

Exercise walk-through

4.6

Monetary Policy

AP Macroeconomics

Monetary policy

Monetary policy : the central bank moves the money supply and interest rates.

- **Expansionary**: buy bonds $\Rightarrow$ rate down (recession)
- **Contractionary**: sell bonds $\Rightarrow$ rate up (inflation)

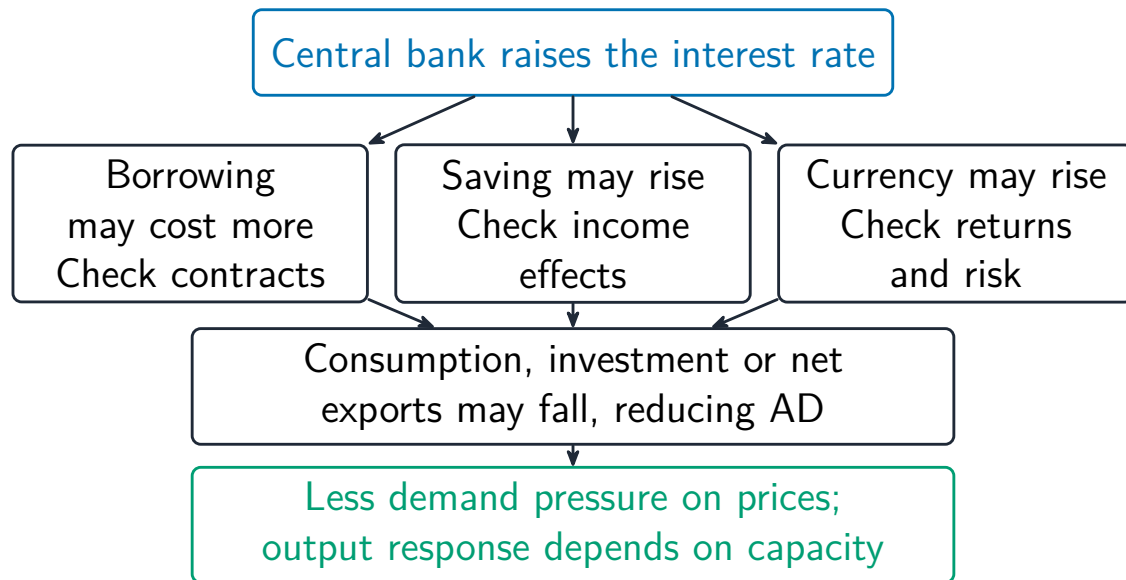
Three tools: open-market operations (main), reserve requirement, discount rate.

$MS \uparrow \Rightarrow i \downarrow \Rightarrow \text{investment} \uparrow \Rightarrow AD \text{ right.}$



Central banks steer rates and credit

How a higher interest rate works through



Lower AD can reduce demand pressure on prices; contracts, confidence and capacity affect the response.

The Fed's tools, by name

Policy rate

The **policy rate** is the rate the central bank targets – the federal funds rate, at which banks lend reserves overnight.

Interest on reserves

Interest on reserves (IOR) is the main modern tool: paying banks on reserves sets a floor under the market rate.

Required reserve ratio

The **required reserve ratio** fixes the fraction of deposits a bank must hold, and so the size of the money multiplier.

Monetary base

Open-market operations change the **monetary base** – currency plus reserves – by buying or selling government bonds.

Households hold **stocks** and bonds as alternatives to money; when the policy rate rises, holding money costs more, so they hold less of it.

Exercises 2.1-2.3

2.1 Define monetary policy.

[1]

2.2 Name the three tools of monetary policy.

[2]

2.3 State the monetary policy used to fight a recession.

[1]

Exercises 2.1-2.3

2.1 Define monetary policy.

[1]

2.1

- the central bank's control of the money supply and interest rates to influence the economy

2.2 Name the three tools of monetary policy.

[2]

2.2

- open-market operations, the reserve requirement, the discount rate

2.3 State the monetary policy used to fight a recession.

[1]

2.3

- expansionary (easy) monetary policy

Exercises 3.1-3.2

3.1 To conduct expansionary monetary policy, a central bank

[1]

☐

A sells bonds

B buys bonds

C raises the reserve ratio

D raises taxes

☐

3.2 When the central bank buys bonds, interest rates

[1]

A rise

B fall

C stay the same

D become negative

Exercises 3.1-3.2

3.1 To conduct expansionary monetary policy, a central bank

[1]

☐

A sells bonds

B buys bonds

C raises the reserve ratio

D raises taxes

3.1 B

- buys bonds.

3.2 When the central bank buys bonds, interest rates

[1]

☐

A rise

B fall

C stay the same

D become negative

3.2 B

- fall.

Exercise 3.3 (a)

3.3 A central bank wants to reduce high inflation.

(a) Name the type of monetary policy it should use.

[1]

Exercise 3.3 (a)

3.3 A central bank wants to reduce high inflation.

(a) Name the type of monetary policy it should use.

[1]

(a)

- contractionary (tight) monetary policy

Exercise 3.3 (b)

3.3 A central bank wants to reduce high inflation.

(b) State one tool and how it would be used.

[2]

Exercise 3.3 (b)

3.3 A central bank wants to reduce high inflation.

(b) State one tool and how it would be used.

[2]

(b)

- e.g. sell bonds on the open market (or raise the reserve ratio / discount rate) to reduce the money supply