Exercise walk-through

Monetary Policy ▪ 4.6

eXercise

You must be able to

- define **monetary policy 货币政策** as the central bank's control of the money supply and interest rates
- distinguish **expansionary** (easy) from **contractionary** (tight) monetary policy
- describe the tools: **open-market operations 公开市场操作**, the reserve requirement, and the discount rate
- trace how a change in interest rates affects investment, AD, and output

Method — Monetary policy

The central bank's control of the **money supply** and **interest rates** to steer the economy.

Method — Expansionary vs contractionary

- **Expansionary** — buy bonds, cut the reserve ratio or discount rate $\rightarrow$ rates **down** $\rightarrow$ AD **up** (fights recession).
- **Contractionary** — the reverse (fights inflation).

Method — The tools and transmission

Open-market operations, the **reserve requirement**, and the **discount rate**. Lower rates $\rightarrow$ more investment $\rightarrow$ higher AD $\rightarrow$ higher output.

Practice 2.1 ▪ 1 mark

Define monetary policy.

Solution 2.1

Method: Monetary policy

Worked steps

the central bank's control of the money supply and interest rates to influence the economy **B1**.

Practice 2.2 ▪ 2 marks

Name the three tools of monetary policy.

Solution 2.2

Method: Monetary policy

Worked steps

open-market operations, the reserve requirement, the discount rate **B1** **B1** *for any two; for all three*.

Practice 2.3 ▪ 1 mark

State the monetary policy used to fight a recession.

Solution 2.3

Method: Monetary policy

Worked steps

expansionary (easy) monetary policy B1 .

Exam-style 3.1 ▪ 1 mark

To conduct expansionary monetary policy, a central bank

A sells bonds

B buys bonds

C raises the reserve ratio

D raises taxes

Solution 3.1

Method: Monetary policy

A sells bonds

B buys bonds ✓

C raises the reserve ratio

D raises taxes

Worked steps

B.

Exam-style 3.2 ▪ 1 mark

When the central bank buys bonds, interest rates

A rise

B fall

C stay the same

D become negative

Solution 3.2

Method: Monetary policy

A rise

B fall ✓

C stay the same

D become negative

Worked steps

B.

Exam-style 3.3 ▪ 1 mark

A central bank wants to reduce high inflation.
(a) Name the type of monetary policy it should use.
(b) State one tool and how it would be used.

Solution 3.3

Method: Monetary policy

Worked steps

(a) contractionary (tight) monetary policy **B1**. (b) e.g. sell bonds on the open market (or raise the reserve ratio / discount rate) to reduce the money supply **B1** **B1**.