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Week #4

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Week Four: The Federal Reserve and Monetary Policy

Monetary or fiscal policy? Monetarism or Keynesianism? These became the macroeconomic questions in the 1970s as the nation found itself first fighting a soaring inflation and then a virulent stagflation. In this lesson, we're going to explore these questions and explain how Monetarism emerged in the 1970s to challenge the Keynesian orthodoxy.

To do so, we first have to describe our money and banking system and explain how the nation's central bank, the Federal Reserve, creates money. Once we get these basics down, we can then talk about how contractionary or expansionary monetary policy may be used to fight inflation or close a recessionary gap.

The major policy point we shall make is this-and it may seem paradoxical-it is actually the Keynesian economists, not the Monetarists, who support an activist role for monetary policy in fighting recessions and inflation.

Key Questions for Week Four: The Federal Reserve and Monetary Policy

1. What is monetary policy?
2. What are the three kinds of money?
3. What are the three functions of money?
4. What is the difference between M 1, M2, M3, and L?
5. What is the price of money?
6. Name three reasons why interests rates differ.
7. If the nominal interest rate is 8 percent per year and the inflation rate is 3 percent per year, what is the real interest rate?
8. Name and describe the two sources of money demand.
9. What three characteristics of the modern banking system were also characteristics of the early goldsmiths?
10. Suppose the reserve requirement is 20%. What is the money multiplier?
11. How does a bank run occur?
12. Why is the Federal Reserve considered the "lender of last resort?"
13. What are the three instruments of monetary policy? Which is the most important?
14. Suppose the Federal Reserve sells bonds. Is this contractionary or expansionary monetary policy?

15. Describe the monetary transmission mechanism.
16. Illustrate how to close a recessionary gap using monetary policy in the aggregate supply-aggregate demand framework.
17. Which is more precise: monetary policy or fiscal policy? Why?
18. What is the Keynesian view of monetary policy?
19. What is the Monetarist view of monetary policy?
20. Explain the Great Depression from a Monetarist perspective.
21. Use the Aggregate Supply-Aggregate Demand framework to illustrate stagflation.
22. What is the Keynesian dilemma created by stagflation?
23. What is the Monetarist solution to stagflation?

Week #4 Quiz

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