Chapter 18 Monetary Policy Answers

1. What did the Federal Reserve do in response to COVID-19?

a. It raised its discount rate to drive up interest rates.
b. It conducted open market selling to drive up interest rates.
c. It conducted open market purchases to drive up interest rates.
d. It increased the reserve requirements to drive down interest rates.
e. It suspended all reserve requirements to drive down interest rates.

2. If the interest rate on a loan is higher than the expected return from an investment:

a. a rational firm will take out a loan for the investment.
b. the Federal Reserve will conduct contractionary monetary policy.
c. a rational firm will not take out a loan for the investment.
d. the Federal Reserve will conduct expansionary monetary policy.
e. the government will conduct expansionary fiscal policy.

3. Expansionary monetary policy causes ________ the aggregate demand curve.

a. a leftward shift of
b. a rightward shift of
c. a flattening of
d. movement downward along
e. movement upward along

4. Expansionary monetary policy:

a. lowers interest rates, causing aggregate demand to shift to the right.
b. lowers interest rates, causing aggregate demand to shift to the left.
c. raises interest rates, causing aggregate demand to shift to the right.
d. raises interest rates, causing aggregate demand to shift to the left.
e. lowers interest rates, causing short-run aggregate supply to shift to the right.

5. Holding all else constant, in the short run, an increase in the money supply can cause a(n):

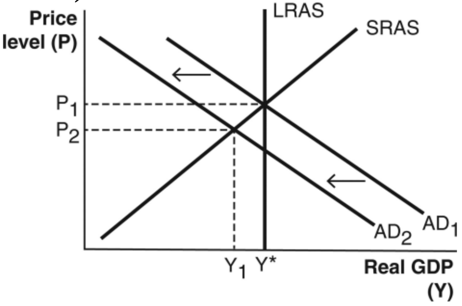
a. increase in unemployment.
b. lower rate of inflation.
c. decrease in the price level.
d. decrease in real gross domestic product (GDP).
e. increase in real GDP.

6. Expansionary monetary policy ________ interest rates, which ________ the ________.

a. raises; increases; aggregate demand
b. raises; decreases; aggregate demand
c. lowers; decreases; demand for loanable funds
d. lowers; increases; quantity demanded of loanable funds
e. raises; increases; quantity demanded of loanable funds

7. Which of the following aggregate demand–aggregate supply models illustrates the short-run effects of expansionary monetary policy?

A)



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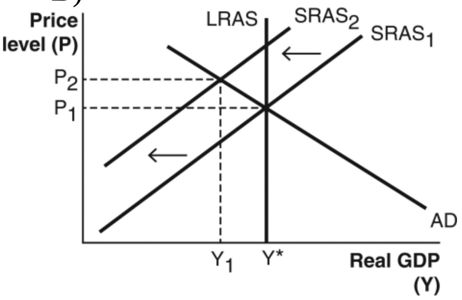

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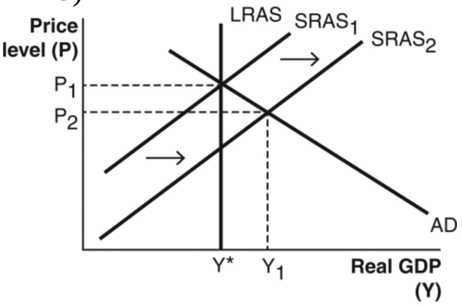

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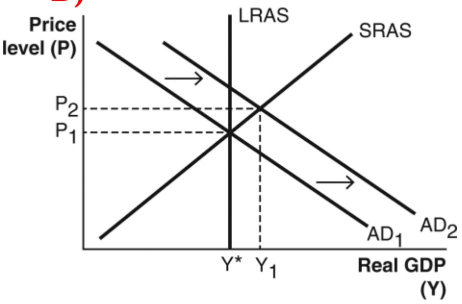
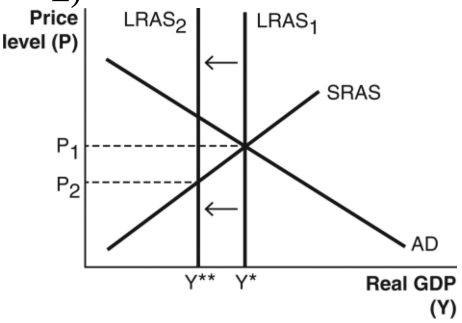
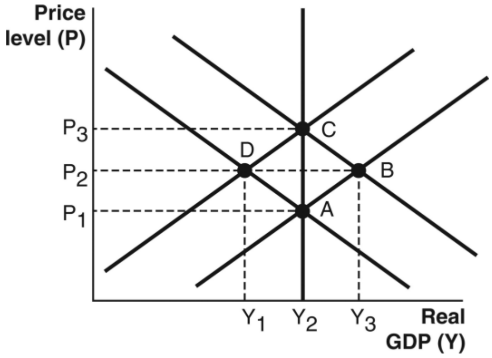


E)



Refer to the following graph to answer the next two questions.



8. According to the graph, expansionary monetary policy will cause an economy that is initially at full-employment output to go from equilibrium ________ to equilibrium ________ in the short run.

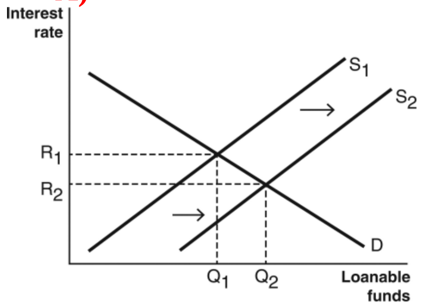
a. A; C
b. A; B
c. A; D
d. C; B
e. C; D

9. According to the graph, if the economy started at full-employment output, expansionary monetary policy would cause real gross domestic product (GDP) to ________ in the short run.

a. increase from Y_1 to Y_2
b. increase from Y_1 to Y_3
c. decrease from Y_2 to Y_1
d. decrease from Y_3 to Y_2
e. increase from Y_2 to Y_3

10. Which of the following graphs illustrates the effects of expansionary monetary policy on the loanable funds market?

A)



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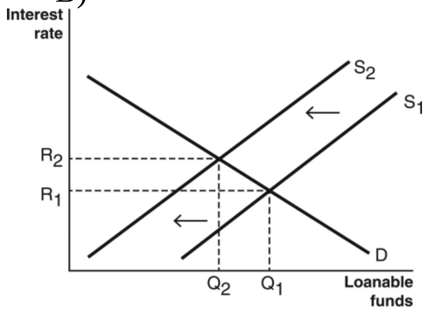
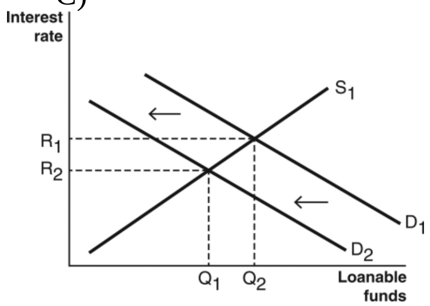
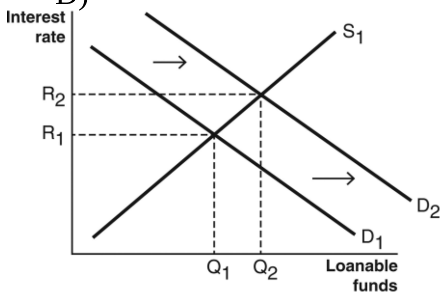


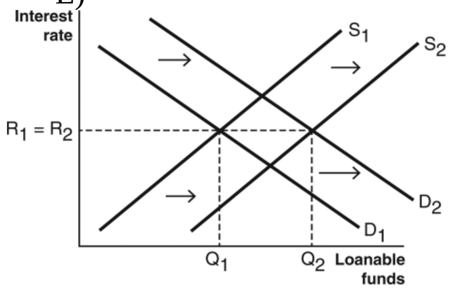
C)



D)



E)



11. What did the Federal Reserve do in response to the Great Recession?

a. It raised its discount rate to drive up interest rates.
b. It conducted open market selling to drive up interest rates.
c. It conducted open market purchases to drive down interest rates.
d. It increased the reserve requirements to drive down interest rates.
e. It decreased the reserve requirements to drive up interest rates.

12. When a central bank implements expansionary monetary policy, there is a background assumption that:

a. it will need to counteract the effects with contractionary policy in the near future.
b. the government will also be implementing expansionary fiscal policy.
c. the government is currently implementing contractionary fiscal policy.
d. the effects will only be short-term.
e. the effects will be long-term.

13. ________ policy is when a central bank acts to decrease the money supply in an effort to control an economy that is expanding too quickly.

a. Inflationary monetary
b. Expansionary fiscal
c. Contractionary monetary
d. Cyclical monetary
e. Countercyclical fiscal

14. If the interest rate on a loan is lower than the expected return from an investment:

a. a rational firm will take out a loan for the investment.
b. the Federal Reserve will conduct contractionary monetary policy.
c. a rational firm will not take out a loan for the investment.
d. the Federal Reserve will conduct expansionary monetary policy.
e. the government will conduct expansionary fiscal policy.

15. Contractionary monetary policy causes ________ the aggregate demand curve.

a. a leftward shift of
b. a rightward shift of
c. a flattening of
d. movement downward along
e. movement upward along

16. Contractionary monetary policy ________ interest rates, causing ________ to shift to the ________.

a. lowers; aggregate demand; right
b. lowers; aggregate demand; left
c. raises; aggregate demand; right
d. raises; aggregate demand; left
e. lowers; short-run aggregate supply; right

17. Holding all else constant, in the short run, a decrease in the money supply can cause a(n):

a. decrease in unemployment.
b. high rate of inflation.
c. increase in the price level.
d. decrease in real gross domestic product (GDP).
e. increase in real GDP.

18. Contractionary monetary policy ________ interest rates, by ________ the ________.

a. raises; decreasing; supply of loanable funds
b. raises; increasing; demand for loanable funds
c. lowers; decreasing; short-run aggregate supply
d. lowers; increasing; aggregate demand
e. raises; increasing; long-run aggregate supply

19. During a financial crisis hit hard by bank failures, the money supply:

a. decreases because people start putting money into savings accounts.
b. increases because people start putting money into savings accounts.
c. increases because people start withdrawing their money from banks.
d. decreases because people start withdrawing their money from banks.
e. increases because people spend more instead of saving more.

20. What would economists today argue should have been done to limit the severity of the Great Depression?

a. The Fed should have done more to decrease the money supply at the onset.
b. The Fed should have done more to decrease the inflation rate at the onset.
c. The Fed should have reacted more quickly to decrease the money supply.
d. The Fed should have waited longer before trying to raise the money supply.
e. The Fed should have done more to offset the decline in the money supply at the onset.

21. When participants in the economy are able to adjust their expectations regarding inflation, this:

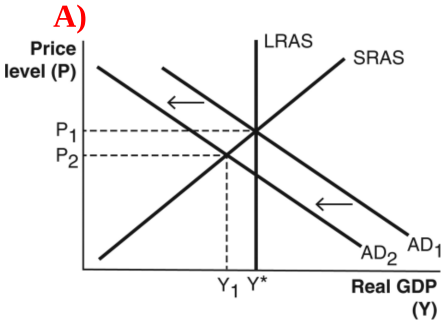
a. discourages capital investment.
b. encourages households to save.
c. makes interest rates less important.
d. dampens the effects of monetary policy.
e. promotes increased productivity.

22. The idea that the money supply does not affect real economic variables in the long run is called:

a. rational expectations theory.
b. adaptive expectations theory.
c. active monetary policy.
d. monetary neutrality.
e. passive monetary policy.

23. Which of the following aggregate demand–aggregate supply graphs illustrate the short-run effects of contractionary monetary policy?

A)



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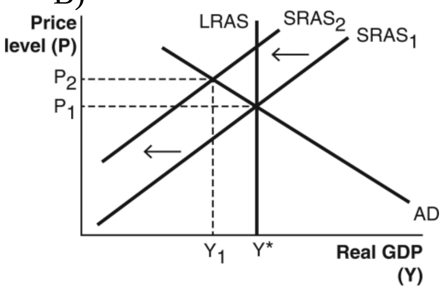

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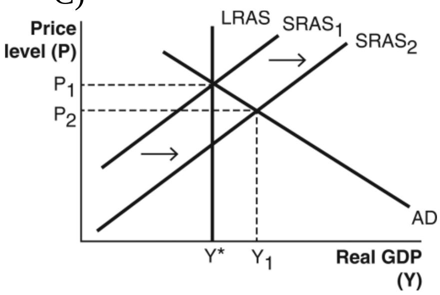
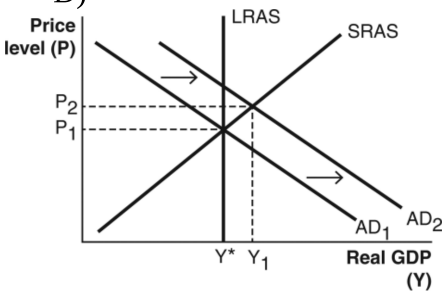
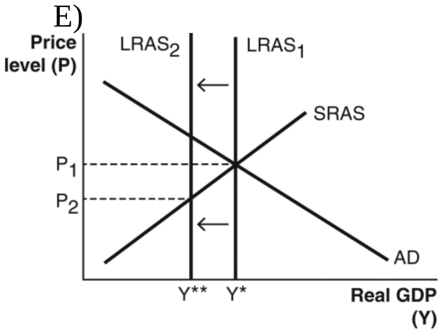


D)

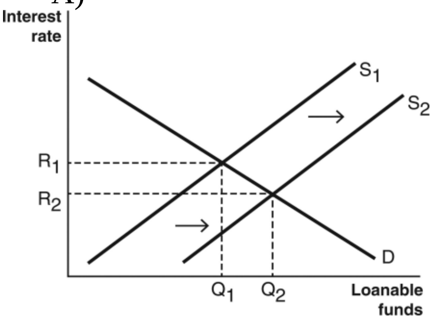


E)



24. Which of the following graphs illustrate the effects of contractionary monetary policy on the loanable funds market?

A)



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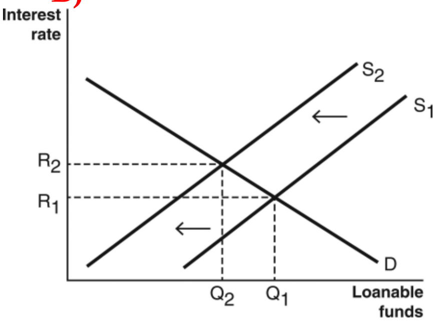
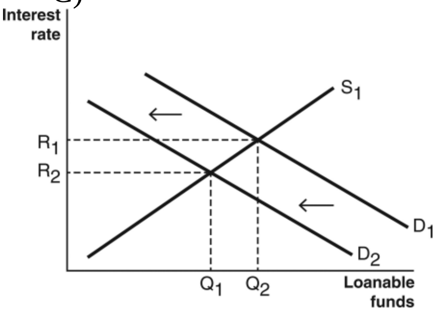
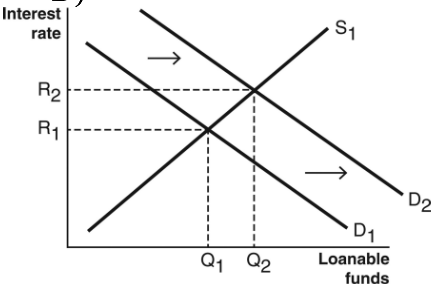


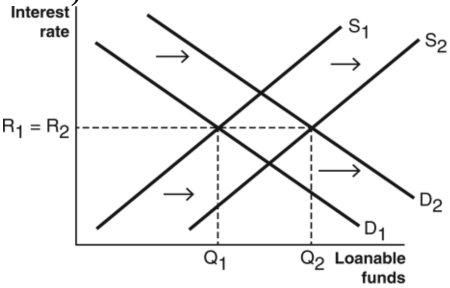
C)



D)



E)



25. Which of the following explains why resource prices are often the slowest prices to adjust?

a. Resource prices are not affected by inflation.
b. Resource prices are often set by lengthy contracts.
c. Resource prices are often set by governments.
d. Resource prices are not reported in the consumer price index (CPI).
e. Resource prices are all tied to inflation.

26. An active monetary policy that attempts to smooth out the business cycle would involve conducting ________ monetary policy during recessions and ________ monetary policy during expansions.

a. contractionary; contractionary
b. expansionary; expansionary
c. contractionary; expansionary
d. expansionary; contractionary
e. countercyclical; expansionary

27. To avoid the negative effects of unexpected inflation, workers have an incentive to:

a. lock in their current wages for years.
b. stay unemployed during years of inflation.
c. never negotiate wage contracts.
d. change jobs regularly.
e. expect a certain level of inflation and negotiate their contracts accordingly.

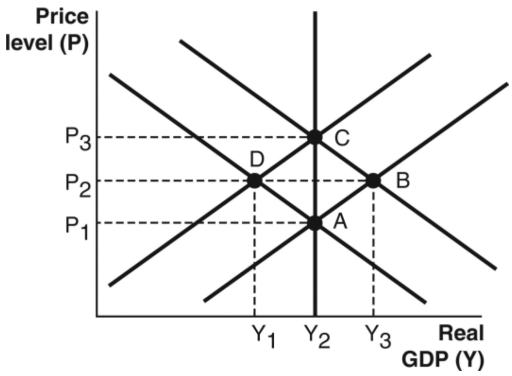
28. Unexpected inflation harms workers and other resource suppliers who have ________ prices in the ________ run.

a. flexible; short
b. fixed; short
c. fixed; long
d. flexible; short
e. flexible; medium

29. Monetary policy has real effects only when:

a. the government budget is balanced.
b. inflation is expected.
c. some prices are sticky.
d. unemployment is at the natural rate.
e. the economy is in equilibrium.

Refer to the following graph to answer the next two questions.



30. According to the graph, expansionary monetary policy starting at full-employment equilibrium will go from Point ________ to Point ________ in the short run and then to Point ________ in the long run.

a. A; B; A
b. A; D; A
c. A; D; C
d. A; B; C
e. C; B; A

31. According to the graph, contractionary monetary policy starting at full-employment equilibrium will go from Point ________ to Point ________ in the short run and then to Point ________ in the long run.

a. A; D; A
b. C; B; A
c. A; D; C
d. C; D; C
e. C; D; A

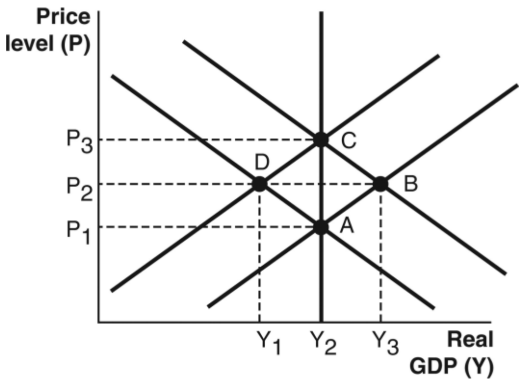
32. Which 2009 condition limited the Federal Reserve's options in the use of traditional expansionary monetary policy?

a. Open market operations had previously failed.
b. The Great Recession had ended.
c. The federal funds rate was already at 0%.
d. Inflation was rising at an unexpected rate.
e. The Great Recession was worsening.

33. Between 1929 and 1933, what triggered a major contraction in the money supply?

a. high inflation
b. insufficient capital investment
c. high unemployment
d. excess consumption
e. bank failures

Refer to the following graph to answer the next question.



34. According to the graph, if an expansionary monetary policy is fully expected, that policy will cause an economy initially in full-employment equilibrium to move from Point:

a. A to B.
b. A to B and back to A.
c. A to B to C.
d. A to C and back to A.
e. A to C.

35. What is meant by the phrase "prices are sticky"?

a. In the short run, suppliers expect future prices to remain constant.
b. In the short run, contracts, loans, and wages are often fixed.
c. In the long run, contracts, loans, and wages are often fixed.
d. In the long run, suppliers expect future prices to remain constant.
e. In the long run, people demand constant real wages.

36. In the short run, how does the price level rise as a result of expansionary monetary policy?

a. Through a shift of the short-run aggregate supply curve.
b. Through a shift of the long-run aggregate supply curve.
c. Through movement along the long-run aggregate supply curve.
d. Through movement along the short-run aggregate supply curve.
e. Through movement along the aggregate demand curve.

37. The Federal Reserve kept the federal funds interest rate target near zero from ________ to ________.

a. 2007; 2009
b. 2008; 2011
c. 2009; 2015
d. 2010; 2017
e. 2011; 2019

38. Why does a decrease in the supply of loanable funds cause a short-run shift in aggregate demand?

a. The price of loanable funds drops, which discourages borrowing for purposes of consumption. Consumption is a component of aggregate demand.
b. The price of loanable funds drops, which promotes borrowing for purposes of investment, which then shifts short-run aggregate supply, and with it, short-run aggregate demand.
c. **The price of loanable funds rises, which discourages borrowing for purposes of investment. Investment is a component of aggregate demand.**
d. The demand for loanable funds rises to keep the quantity of loanable funds constant. Money that is not loaned out is instead spent on consumption, which is a component of aggregate demand.
e. The price of loanable funds falls, which makes it easier for the government to borrow to fund government spending. Government spending is a component of aggregate demand.

39. What was one major reason for the contraction of the money supply at the start of the Great Depression?

a. Household wealth was increasingly tied up in home values.
b. Tax cuts left the government with less money to spend to boost aggregate demand.
c. Loosened bank regulations caused the value of the money multiplier to drop.
d. **Bank failures led people to start holding money outside the banking system.**
e. Loosened trade regulations caused money to flow overseas in exchange for imports.

40. The quantitative easing engaged in by the Fed during the Great Recession consisted of:

a. purchasing gold.
b. selling long-term bonds.
c. **purchasing long-term bonds.**
d. selling high-risk stocks.
e. purchasing high-risk stocks.

41. ________ would be hurt by unexpected inflation.

a. A worker whose contract includes a cost-of-living adjustment clause
b. A car buyer who is paying off fixed-rate five-year auto loan
c. **A bank that just issued a fixed-rate mortgage loan to a first-time homebuyer**
d. A home-repair contractor who charges by the hour

42. You have just been chosen to be an economist on the Board of Governors for the Federal Reserve. After years of constant growth, the U.S. economy begins to fall into a recession. If you were to recommend an activist monetary policy, which broad type would you suggest to the board, and why?

Answer: Expansionary monetary policy should be suggested as it is intended to increase the overall production in the economy and, in turn, increase overall income. By conducting expansionary monetary policy, the effects of a recession can, in theory, be limited in the short run.

43. Explain the impact of expansionary monetary policy on the entire macroeconomy in the short run.

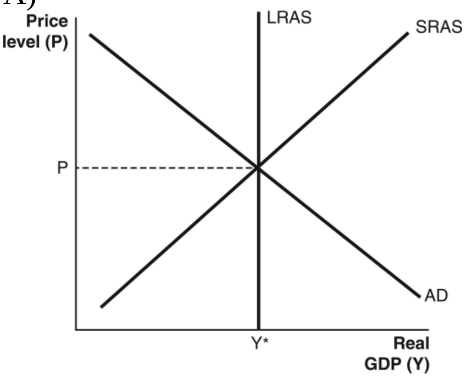
Answer: The Federal Reserve increases the money supply to implement expansionary monetary policy. The main way it does this is by the use of open market operations. Expansionary monetary policy involves the purchase of bonds from financial institutions; normally, these are short-term Treasury securities. Treasury securities are one important part of the loanable funds market, where lenders buy securities and borrowers sell securities. If the Fed buys bonds, it increases the supply of loanable funds in the market. The price in the loanable funds market is the interest rate, and when the supply of loanable funds increases, the interest rate decreases. Lower interest rates increase the quantity of investment demand, just as lower prices increase the quantity demanded in any product market. Investment is one component of aggregate demand, so increases in investment indicate an increase in aggregate demand. In the short run, increases in aggregate demand increase output and lowers the unemployment rate.

44. Answer the following questions using an aggregate demand–aggregate supply model when appropriate.

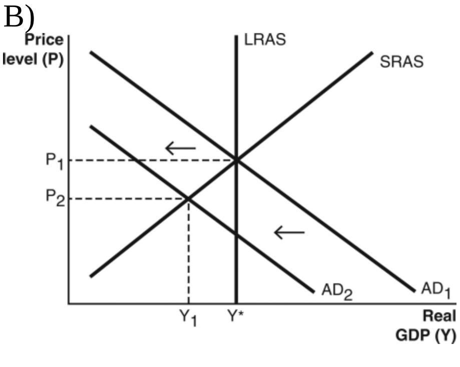
A) Use a graph to represent an economy at long-run equilibrium.
B) Now graph what happens when aggregate demand decreases.
C) Referring to your graph, is this economy in an expansion or recession now?
D) Continuing with the economy you graphed above, which broad type of activist monetary policy would you suggest be adopted by the Federal Reserve?
E) What will the policy you suggested do to your aggregate demand–aggregate supply model?

Answer:

A)



B)



C) Because $Y_1 < Y^*$, this economy is in a recession.

D) Expansionary monetary policy should be enacted by the Federal Reserve to try to push aggregate demand to the right.

E) This policy will shift the aggregate demand curve to the right, making the economy move back toward full-employment output.

45. Explain how expansionary monetary policy can lead to inflation and discuss the types of individuals who are hurt by unexpected inflation.

Answer: Expansionary monetary policy increases the money supply in an economy. At first, this will cause a real effect on the economy because there is more money to spend. Over time, prices will adjust to this increase in the money supply, causing the price level to rise. If this rise in the price level is unexpected, it will hurt those individuals who have signed contracts and did not take into account the possibility of this future inflation. It would also hurt a lender who agreed to a fixed interest rate.

46. Because you are an economics student, your parents are always asking you about the macroeconomy. Over the past few months, they have seen the economy expanding at a very fast pace, and they are worried about inflation. Your parents ask you: "What type of monetary policy do you expect the Federal Reserve to conduct if it expected high levels of inflation on the horizon?" Explain your answer.

Answer: If high inflation was expected, the Federal Reserve would want to conduct contractionary monetary policy to try to limit inflation. Contractionary monetary policy decreases the money supply, which leads to higher interest rates through the market for loanable funds. These higher interest rates lead to a decrease in both consumption and investment, which leads to a downward pressure on prices.

47. Answer the following questions using an aggregate demand–aggregate supply model when appropriate.

A) Use an aggregate demand–aggregate supply model to represent an economy at long-run equilibrium.

B) Show what happens on your model when aggregate demand increases.

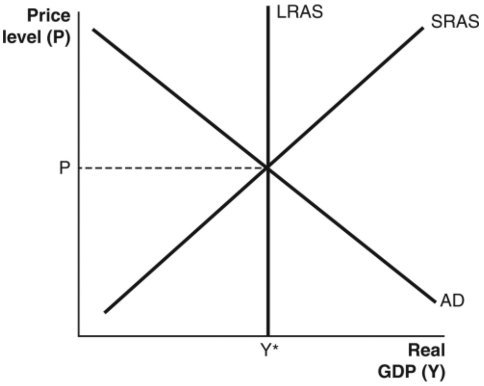
C) Is the economy you modeled in an expansion or recession now?

D) Continuing with the economy you are building, which broad type of activist monetary policy would you suggest be adopted by the Federal Reserve?

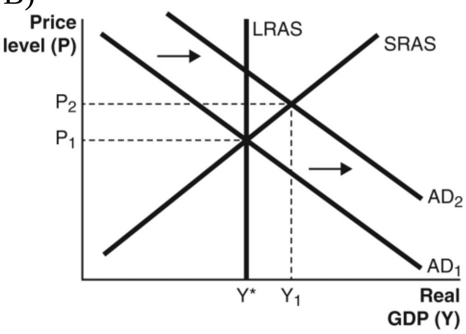
E) What will your suggested policy do to your aggregate demand–aggregate supply model in the short run?

Answer:

A)



B)



C) Because $Y_1 > Y^*$, this economy is in an expansion.

D) Contractionary monetary policy should be enacted by the Federal Reserve to try to move aggregate demand to the left, in order to fight off inflation.

E) This policy will shift the aggregate demand curve back to the left, making the economy move toward full-employment output in the short run.