Reading15

MONETARY POLICY

1. (A) **Buy Treasury securities and decrease bank reserve requirements.**

   Explanation

   If the economy is in a recession, the Fed is likely to attempt to decrease short-term interest rates. Thus, the Fed will buy Treasury securities and decrease bank reserve requirements.

   (Module 15.1, LOS 15.b)

2. (B) **Requiring the banking system to tighten or loosen its credit policies.**

   Explanation

   The U.S. Federal Reserve can encourage or persuade banks as a whole to tighten or loosen their credit policies, but it cannot compel them to do so.

   (Module 15.1, LOS 15.b)

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3. (A) **If the Fed wants to stimulate the economy, it will sell Treasury securities to banks.**

   Explanation

   If the Fed intends to stimulate the economy, they will buy, not sell, Treasury securities. Buying Treasury securities injects reserves into the banking system.

   (Module 15.1, LOS 15.b)

4. (C) **3%.**

   Explanation

   Because they consider deflation to be disruptive to an economy, central banks typically choose inflation targets and bands that do not include a negative rate of inflation.

   (Module 15.2, LOS 15.c)

5. (A) **GDP growth in the short run.**

   Explanation

   If the central bank has a price stability mandate, it will most likely respond to the above target inflation rate by decreasing the money supply, even though GDP growth is in a recessionary phase. Decreasing the money supply will result in higher short-term interest rates and appreciation of the currency, but will likely cause GDP growth to decrease further in the short run.

   (Module 15.1, LOS 15.a)

6. (C) **Incorrect Incorrect**

Explanation

If the Fed increases the money supply and real interest rates decline, U.S. investors will seek higher real rates of return abroad and the U.S. dollar will depreciate as the dollar will be exchanged for foreign currencies in order to buy the foreign investments. Likewise, the decrease in real interest rates will reduce the inflow of funds from abroad as foreign investors seek higher rates of return outside the U.S. With a dollar that has depreciated, U.S. exports should increase, as U.S. products will become cheaper for foreign buyers. As such, both statements are incorrect.

(Module 15.1, LOS 15.b)

7. (B) **target independence.**

Explanation

Target independence means the central bank defines how inflation is computed, sets the target inflation level, and determines the horizon over which the target is to be achieved. Central banks that have operational independence are allowed to determine the policy rate. Transparency refers to the degree to which central banks report to the public on the state of the economic environment and is one of the three essential qualities of an effective central bank.

(Module 15.2, LOS 15.c)

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8. (B) **inflation rate is likely to increase.**

Explanation

The central bank should increase target interest rates when the economy is growing at an unsustainable (above-full-employment) level. Decreasing the target overnight rate is likely to further increase aggregate demand and cause inflation to accelerate, which will be detrimental to the long-term growth rate of the economy.

(Module 15.1, LOS 15.b)

9. (C) **between 2% and 3%.**

Explanation

Central banks typically define price stability as a stable inflation rate of about 2% to 3%. A target of zero is not typically used because it would risk deflation.

(Module 15.1, LOS 15.a)

10. (C) **Lending money to government agencies.**

Explanation

Lending money to government agencies is not typically a function of a central bank. Central bank functions include controlling the country's money supply to keep inflation within acceptable levels and promoting a sustainable rate of economic growth, as well as issuing currency and regulating banks.

(Module 15.1, LOS 15.a)

11. (A) decrease the policy rate and make open market purchases of securities.

Explanation

Decreasing the policy rate, decreasing reserve requirements, and purchasing securities in the open market are expansionary monetary policy actions.

(Module 15.1, LOS 15.b)

12. (A) Contractionary fiscal policy and expansionary monetary policy.

Explanation

Contractionary fiscal policy combined with expansionary monetary policy is more likely to increase private sector growth and decrease the government share of GDP than the other policy combinations.

(Module 15.1, LOS 15.d)

13. (B) A decrease in the discount rate.

Explanation

A decrease in the Fed's lending rate is a monetary tool that the Fed can use to increase the money supply, thereby increasing aggregate demand during recessionary times when there is high unemployment. An increase in the reserve requirements and the sale of bonds by the Fed would all be restrictive monetary policies that would reduce the amount of money in the economy and reduce aggregate demand.

(Module 15.1, LOS 15.d).

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14. (A) neutral interest rate.

Explanation

The neutral interest rate is the sum of the trend rate of real economic growth and the target inflation rate. Monetary policy is expansionary if the policy rate is less than the neutral interest rate and contractionary if the policy rate is greater than the neutral interest rate.

(Module 15.2, LOS 15.c)

15. (B) decreased, which reduces the amount of money banks are able to lend, causing an increase in the federal funds rate.

Explanation

When the Federal Reserve wants to increase the federal funds rate through open market operations, it sells government securities. Open-market sales reduce bank reserves and cause the federal funds rate to increase.

(Module 15.1, LOS 15.b)

16. (A) Deflation.

Explanation

Deflation is difficult for central banks to address when policy rates cannot be lowered any further. Inflation can be addressed by contractionary monetary policy. Stagflation is difficult to address because monetary policy cannot pursue higher growth and lower inflation at the same time.

(Module 15.2, LOS 15.c)

17. (B) the policy rate.

Explanation

A central bank is said to have operational independence if it has the authority to determine the policy rate independently. Determining how inflation is calculated and the time horizon for achieving its target rate of inflation refer to a central bank that has target independence.

(Module 15.2, LOS 15.c)

18. (A) buy Treasury securities.

Explanation

Buying Treasury securities pumps money into the economy, lowering interest rates. Higher reserve requirements will restrict the money supply, causing rates to rise. The Federal Reserve has no direct control over the yield on existing Treasury securities.

(Module 15.1, LOS 15.b)

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19. (A) economic actors base decisions on the central bank's stated inflation targets.

Explanation

If a central bank has credibility, economic actors come to believe the inflation rate will be near the central bank's target and factor this inflation rate into their decisions. Periodic inflation reports enhance the transparency of a central bank. A central bank that determines both the policy rate and the method for computing the inflation rate is said to have independence.

(Module 15.2, LOS 15.c)

20. (A) Sell Treasury securities, causing aggregate demand to decrease.

Explanation

If the Federal Reserve wants to slow inflation, it needs to decrease aggregate demand (i.e., business investment, consumer purchases of durable goods, and exports). To accomplish this, the Federal Reserve could engage in open market sales of Treasury securities.

(Module 15.1, LOS 15.b)

21. (A) a liquidity trap.

Explanation

Deflation is often associated with liquidity trap conditions. A liquidity trap is a situation in which demand for money becomes highly elastic. Expanding the money supply has little effect on economic activity under these conditions because individuals and firms choose to hold the additional money in cash. "Bond market vigilantes" is an expression referring to the fact that expansionary monetary policy may cause long-term interest rates to increase, instead of decreasing as intended, if bond market participants expect the expansionary policy to increase future inflation rates.

(Module 15.2, LOS 15.c)

22. (B) Exports increase.

Explanation

Expansionary monetary policy decreases interest rates. This should cause the domestic currency to depreciate, which should increase foreign demand for the country's exports.

(Module 15.1, LOS 15.b)

23. (A) neutral.

Explanation

The neutral rate of interest is real trend rate of economic growth plus the inflation target. In this example, the neutral rate = 2.5% + 2.5% = 5.0%. Because the policy rate is the same as the neutral rate of interest, monetary policy is neither contractionary nor expansionary.

(Module 15.2, LOS 15.c)

24. (A) contractionary.

Explanation

Monetary policy is contractionary when the policy rate is greater than the neutral rate, which is the sum of the real trend rate of economic growth and the target rate of inflation. Here, the neutral rate is 3% + 2% = 5% and the policy rate of 6% is greater than the neutral rate. Monetary policy is expansionary when the policy rate is less than the neutral interest rate.

(Module 15.2, LOS 15.c)

25. (C) increased more than the growth in the money supply.

Explanation

The equation of exchange is $MV = PY$. If velocity (V) is increasing faster than real output (Y), inflation (P) would have to be increasing faster than the money supply (M) to keep the equation in balance.

(Module 15.1, LOS 15.b)

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26. (B) **Independence, credibility, and transparency.**

Explanation

A central bank that is independent from political interference, possesses credibility, and exhibits transparency is more likely to achieve its monetary policy objectives than a central bank that lacks these qualities. The other characteristics listed in the answer choices relate to financial statements and financial reporting standards.

(Module 15.2, LOS 15.c)

27. (C) **the foreign exchange value of the currency.**

Explanation

Contractionary monetary policy is likely to increase the value of the domestic currency in the foreign exchange market, which decreases foreign demand for the country's exports. Contractionary monetary policy should cause both securities prices and expectations for economic growth to decrease, each of which is likely to cause consumers to decrease spending.

(Module 15.1, LOS 15.b)

28. (A) **Central banks can control short-term interest rates directly, but long-term interest rates are beyond their control.**

Explanation

Central banks can control short-term interest rates directly. However, the decisions of consumers and businesses are based on long-term interest rates, which are beyond the control of central banks. Increasing the money supply will decrease interest rates and decreasing the money supply will increase interest rates.

(Module 15.2, LOS 15.c)

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29. (A) **The private sector as a percentage of GDP will increase.**

Explanation

The private sector will expand as a percentage of GDP because (1) the public sector will decrease as a percentage of GDP due to government spending cuts and (2) lower interest rates should cause the private sector to expand.

(Module 15.1, LOS 15.d)

30. (C) **sell government securities.**

Explanation

Open market operations to sell securities will decrease the outstanding supply of cash balances and increase short-term interest rates. The central bank does not issue long-term bonds but may buy and sell bonds issued by the government. Decreasing reserve requirements or purchasing government securities would tend to decrease short-term interest rates.

(Module 15.1, LOS 15.b)

31. (C) Inflation targeting.

Explanation

Inflation targeting is the most-used tool of central banks for making monetary policy decisions.

(Module 15.2, LOS 15.c)

32. (A) discount rate.

Explanation

Banks are able to borrow from the Fed at the discount rate. The federal funds rate is the interest rate banks charge other banks to borrow reserves from other banks. The prime rate is the rate that commercial banks charge their best customers.

(Module 15.1, LOS 15.a)

33. (A) Collect tax payments.

Explanation

The three functions of a central bank are to issue a country's currency, regulate its banking system, and to manage the money supply. Tax collection is typically conducted by a government agency created specifically to carry out that function.

(Module 15.1, LOS 15.a)

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34. (A) increased exports of U.S. goods.

Explanation

When the Fed sells Treasuries, it causes both short- and long-term interest rates to increase. This rate increase causes the dollar to appreciate, which reduces foreign demand for domestic goods, causing exports to decline. The interest rate increase also puts downward pressure on price levels, which causes inflation to slow.

(Module 15.1, LOS 15.b)

35. (A) Worsen.

Explanation

Contractionary monetary policy likely will cause higher domestic interest rates and attract foreign capital. As foreign capital flows in, the currency will appreciate relative to other currencies. The higher cost of its currency will result in higher cost exports that become less attractive to other countries. Xanadu's trade balance will most likely worsen.

(Module 15.1, LOS 15.b)

36. (B) the same as that of the target currency.

Explanation

Successful exchange rate targeting should result in the same inflation rate in the targeting country as in the country of the target currency.

(Module 15.2, LOS 15.c)

37. (A) control inflation.

Explanation

Although some central banks have other stated goals including stabilizing exchange rates and achieving full employment, the primary objective for a central bank is to control inflation and promote price stability.

(Module 15.1, LOS 15.a)

38. (A) sell government securities in the open market.

Explanation

Selling government securities on the open market reduces bank reserves and drives up the federal funds rate. The other two statements are incorrect because the Federal Reserve does not directly control exchange rates or the prices of government securities.

(Module 15.1, LOS 15.b)

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39. (B) buy government securities.

Explanation

Buying government securities is an expansionary policy that would increase the money supply and allow the inflation rate to increase to the targeted range. Increasing reserve requirements and overnight lending rates are contractionary and would have the opposite effects.

(Module 15.1, LOS 15.b)

40. (A) An increase in the real rate of interest.

Explanation

If the U.S. Federal Reserve decreases the money supply, an increase in nominal and real interest rates will occur. Higher real rates will cause businesses to invest less, which will cause the unemployment rate to increase. Furthermore, households will decrease purchases of durable goods, automobiles, and other items that are typically financed at short-term rates. This will decrease aggregate demand. The decrease in aggregate demand and expenditures will cause incomes to go down, which further decreases consumption and investment. Moreover, this decrease in aggregate demand will decrease real GDP and the price level in the short run and the long run.

(Module 15.1, LOS 15.b)

41. (B) Expansionary fiscal policy and contractionary monetary policy.

Explanation

Expansionary fiscal policy tends to expand the public sector. Contractionary monetary policy tends to contract the private sector.

(Module 15.1, LOS 15.d)

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