What is Monetary Policy?

Worksheet

Monetary policy is the management of money supply and interest rates by a central bank to achieve price stability, full employment, and sustainable economic growth.

Questions

1. Monetary policy is primarily aimed at…

A) Raising government revenue
B) Price stability and full employment
C) Cutting taxes
D) Eliminating all unemployment

2. When the Fed lowers interest rates, it is using…

A) Fiscal policy
B) Expansionary monetary policy
C) Contractionary monetary policy
D) Supply-side policy

3. Open market operations involve…

A) Buying and selling securities
B) Setting tax rates
C) Approving new projects
D) Controlling inflation directly

4. Which action is contractionary?

A) Lowering the discount rate
B) Reducing reserve requirements
C) Selling government bonds
D) Printing new money

5. The Fed lowers the policy interest rate from 3% to 2%. Explain the transmission mechanism.

6. Central bank tightens policy to fight 6% inflation. What tools might it use?

7. The economy is in recession. What expansionary monetary policy actions could help?

8. Define: What is monetary policy?

9. Define: Who implements monetary policy?

10. Define: What are the main tools of monetary policy?

Answer Key

1. B) Price stability and full employment — Central banks target price stability, full employment, and sustainable growth.

2. B) Expansionary monetary policy — Lower rates increase money supply and borrowing, expanding the economy.

3. A) Buying and selling securities — OMOs are the primary tool for controlling money supply.

4. C) Selling government bonds — Selling bonds removes money from circulation, contracting the money supply.

5. Step 1: Fed lowers the federal funds rate Step 2: Banks' borrowing costs fall Step 3: Banks lower lending rates to businesses and consumers Step 4: Businesses invest more; consumers spend more Step 5: Aggregate demand increases, boosting output

6. Step 1: Raise policy interest rate Step 2: Reduce money supply via open market operations (sell securities) Step 3: Higher borrowing costs discourage spending Step 4: Aggregate demand falls Step 5: Inflation pressure decreases

7. Step 1: Lower interest rates to 0.5% Step 2: Purchase government bonds (quantitative easing) Step 3: Money supply increases sharply Step 4: Banks lend more; businesses/consumers borrow more Step 5: Spending rises, output recovers

8. Central bank actions to control money supply and interest rates, aiming for price stability and full employment.

9. The central bank (e.g., Federal Reserve in the US, ECB in Europe).

10. Open market operations (buy/sell securities), discount rate changes, and reserve requirement adjustments.