

Monetary Policy: Definitions 5-2 Hwk

Name: _____ Date: _____ Period: _____

Select the term which corresponds to the statements which follow

- | | | | |
|---|-----------------------------------|---|-------------------------|
| A | transmission mechanism | E | monetary policy |
| B | open market operations | F | time lags |
| C | money market | G | suasion |
| D | monetarist transmission mechanism | H | short term money market |

- 1 **E** The control of the domestic money supply and the level of interest rates to achieve economic objectives.
- 2 **B** Activities of the Federal Reserve in buying and selling government securities from and to authorized dealers in the money market.
- 3 **G** Attempts by the Federal Reserve to modify bank behavior through persuasion and suggestion rather than instruction.
- 4 **F** Delays in the determination of appropriate economic policy or in the transmission of policy solutions on economic behavior.
- 5 **D** The direct operation of monetary policy through the impact on expenditure, aggregate demand and economic activity.
- 6 **A** The process by which monetary policy affects economic activity.
- 7 **C** Institutions which are the main link between the Federal Reserve and the money market, making markets in government securities.
- 8 **H** Where borrowing and lending of short-term funds and the trading of short-term securities occurs.

Monetary Policy Concepts Review

Check the following for the missing terms and concepts.

buy, cost push, current account, decrease, direct, direct or powerful, equation of exchange, fiscal policy, increase, indirect, inflation, interest rates, investment, lower, M= money supply, MV=PY, not change, output, output/prices, P=price, raise, recession, reduced, sell, transmission, V=velocity, Q=output

- 1 To decrease the supply of money, the Federal Reserve could
 - (i) through open market operations **SELL** more government securities. This would eventually **RAISE** the official cash rate which eventually affects other **INTEREST RATES**.
 - (ii) To increase the supply of money the Federal Reserve could through market operations **BUY** more government securities. This would eventually **LOWER** the official cash rate which eventually affects other **INTEREST RATES**.
- 2 The strengths of monetary policy are that it is effective in controlling **INFLATION** and inflationary expectations, more politically expedient, and in the view of monetarists more **DIRECT** than fiscal policy. The weaknesses of monetary policy include
 - (i) it is less effective when the economy is in **RECESSION**
 - (ii) it is less suitable in fighting **COST-PUSH** inflation
 - (iii) its impact in a deregulated financial system is **REDUCED**
- 3 The major difference between Keynesians and Monetarists on the role of monetary policy in the economy is on the **TRANSMISSION** mechanism. Keynesians argue that the response of **INVESTMENT** to interest rate changes is the key to the indirect transmission of monetary policy effects on the economy. Monetarists argue that there is a direct relationship between monetary policy and **OUTPUT**.

The simplest monetarist equation is

$$\mathbf{MV = PQ}$$

This equation is called the **EQUATION OF EXCHANGE** where each symbol represents

M	<u>MONEY SUPPLY</u>	P	<u>PRICE</u>
V	<u>VELOCITY</u>	Y	<u>OUTPUT</u>

Assume that M increases and that V is constant or stable. The effect on price and quantity is that P will **INCREASE** and Q will **NOT CHANGE** when the economy is at full employment. Under this monetarist approach there is a **DIRECT** relationship between monetary policy and **OUTPUT/PRICES** and that the transmission process is **DIRECT**.

- 4 Keynesians, on the other hand argue that monetary policy has only an **INDIRECT** effect on the economy. An increase in M will result in a **DECREASE** in the rate of interest which will stimulate the investment component of aggregate demand. The Keynesian view of the transmission process of monetary policy is that it is **INDIRECT** through the response of investment to changes in **INTEREST RATES**. Keynesians therefore prefer the use of **FISCAL POLICY** to influence economic activity.