Practice Problems: Chapter 15 Monetary Policy

1. If the interest rate on CDs increases from 5% to 10%, the opportunity cost of holding money will ______ and the quantity demanded of money will ______.
   A) increase; decrease
   B) increase; increase
   C) decrease; increase
   D) decrease; decrease

2. The short-term interest rate is the interest rate on financial assets that mature within:
   A) a month.
   B) 6 months.
   C) 1 year.
   D) 5 years.

3. People forgo interest and hold money:
   A) because they are required to.
   B) to reduce their transactions costs.
   C) because there are no substitutes for money.
   D) because banks are too risky.

4. The interest earnings one gives up to hold more liquid assets are:
   A) an opportunity cost.
   B) a transactions cost.
   C) an asset of the company.
   D) a liability of the company.

5. The money demand curve is:
   A) downward-sloping because the opportunity cost of holding money is inversely related to the interest rate.
   B) downward-sloping because the opportunity cost of holding money rises as the interest rate increases.
   C) downward-sloping because the opportunity cost of holding money rises as the interest rate falls.
   D) upward-sloping because the opportunity cost of holding money rises with the interest rate.

6. The slope of the demand curve for money is:
   A) vertical.
   B) horizontal.
C) positive.
D) negative.

7. A decrease in the demand for money would result from:
   A) an increase in income.
   B) an increase in real GDP.
   C) a decrease in the price level.
   D) an increase in nominal GDP.

8. A 20% increase in the aggregate price level will increase the quantity of money demanded by:
   A) 20%.
   B) the money multiplier.
   C) 10%.
   D) half the money multiplier.

9. Improvements in information technology have:
   A) shifted the demand for cash to the right.
   B) decreased the demand for money.
   C) not affected the demand for money.
   D) increased the demand for money.

10. All of the following factors will shift the money demand curve, EXCEPT:
    A) changes in the institutions.
    B) changes in the real GDP.
    C) changes in the aggregate price level.
    D) changes in the interest rate.

11. The demand for money is higher in Japan compared to United States, because:
    A) Japanese banks pay interest on checking accounts.
    B) most stores in Japan do not accept credit cards.
    C) the ATM's are open all night.
    D) average price level is lower in Japan.

12. The federal funds rate is the interest rate on ______, and is controlled by the ________.
    A) loans from the Fed to banks; Federal Open Market Committee
    B) reserves that banks lend to each other; Federal Open Market Committee
    C) loans from the Fed to banks; President and Congress
    D) reserves that banks lend to each other; President and Congress
13. In the liquidity preference model, the money supply is represented by:
A) a vertical line.
B) an upward sloping curve with a slope of $1/V$.
C) a horizontal line.
D) a downward sloping curve with a slope of $1/k$.

14. According to the liquidity preference model, if the interest rate rises above its equilibrium value, the quantity demanded of nonmonetary interest-bearing financial assets ________ and this leads to a ________ in the interest rate.
A) decreases; rise
B) increases; fall
C) decreases; fall
D) increases; rise

Use the following to answer questions 15-16.

**Figure: Money Market I**

15. (Figure: Money Market I) If the money market is initially in equilibrium at point $E$ and the central bank sells bonds, then the interest rate will:
A) move toward point $H$.
B) move toward point $L$.
C) remain at point $E$.
D) shift rightward.

16. (Figure: Money Market I) If the money market is initially in equilibrium at point $E$ and the central bank buys bonds, then the interest rate will:
A) move toward point $H$.
B) move toward point $L$.
C) remain at point $E$.
D) shift leftward.

17. A sale of bonds by the Fed:
A) raises interest rates and increases the money supply.
B) raises interest rates and reduces the money supply.
C) lowers interest rates and reduces the money supply.
D) lowers interest rates and increases the money supply.

Use the following to answer question 18.

**Figure: Changes in the Money Supply**

18. (Figure: Changes in the Money Supply) If the supply of money shifts from $S_1$ to $S_2$, the Fed must have _______ government bonds in the open market.
A) sold
B) bought
C) issued new
D) borrowed

19. Expansionary monetary policy:
A) increases the money supply, interest rates, consumption, and investment.
B) decreases the money supply, interest rates, consumption, and investment.
C) increases the money supply, decreases interest rates, and increases consumption and investment.
D) decreases the money supply, increases interest rates, and decreases consumption and investment.
20. Contractionary monetary policy:
A) is appropriate if there is a recessionary gap.
B) decreases aggregate demand.
C) increases aggregate demand.
D) helps solve the problem of unemployment.

21. To close an inflationary gap using monetary policy, the Fed should ______ the money supply to ______ investment and consumer spending, and shift the aggregate demand curve to the _______.
A) increase; increase; left
B) decrease; decrease; left
C) increase; increase; right
D) decrease; decrease; right

22. Given a recessionary gap, the Fed will use monetary policy to ______ interest rates and ______ aggregate demand.
A) increase; increase
B) increase; decrease
C) decrease; increase
D) decrease; decrease

Use the following to answer questions 23-24.

Figure: The Money Supply and Aggregate Demand

23. (Figure: The Money Supply and Aggregate Demand) Panel (a) illustrates what happens when the Fed decides to ______ the money supply and ______ interest rates.
A) lower; lower
24. (Figure: The Money Supply and Aggregate Demand) Panel ______ illustrates what happens when the Fed decides to ______ government bonds and ______ the money supply.
A) (a); sell; increase
B) (b); buy; increase
C) (b); sell; decrease
D) (a); buy; decrease

Use the following to answer question 25.

**Figure: Economic Adjustments**

25. (Figure: Economic Adjustments) Assume that the economy is at point c. An increase in the money supply would cause:
A) a shift of the $SRAS_1$ curve to $SRAS_2$.
B) a shift of the $SRAS_2$ curve to $SRAS_1$.
C) a shift of the $AD_1$ curve to $AD_2$.
D) a shift of the $AD_2$ curve to $AD_1$.

26. To fight inflation, the Fed should conduct _____ monetary policy to ______ interest rates and shift aggregate demand to the _____.
A) contractionary; increase; left
B) contractionary; increase; right
C) expansionary; decrease; right
D) expansionary; increase; left
27. If the Federal Reserve sets the federal funds rate on the basis of inflation and output gap, then the Fed is following:
A) inflation targeting.
B) the Taylor rule.
C) money illusion.
D) the quantity theory.

28. When the central bank announces the inflation rate that it is trying to achieve and sets policy to reach that rate, it is using:
A) monetary neutrality policy.
B) the Taylor rule for monetary policy.
C) inflation targeting.
D) fiscal policy.

29. Which of the following describes the difference between the Taylor rule and inflation targeting?
B) The Taylor rule responds to past inflation, and inflation targeting is based on a forecast of future inflation.
C) Inflation targeting responds to past inflation, and the Taylor rule is based on a forecast of future inflation.
D) Inflation targeting is a strategy used in conducting fiscal policy, while the Taylor rule is used in monetary policy.

Use the following to answer question 30.

**Figure: Monetary Policy and the AD–SRAS Model**

30. (Figure: Monetary Policy and the AD–SRAS Model) The economy is likely to move from point $i$ to point $h$ due to:
31. In the long run, changes in the money supply:
A) affect both the aggregate price level and aggregate output.
B) affect only the price level but they do not change aggregate output.
C) affect aggregate output but not the aggregate price level.
D) have no impact on either the aggregate price level or aggregate output.

32. Monetary neutrality implies that in the long run:
A) monetary policy does not affect the level of economic activity.
B) aggregate supply is independent from monetary policy.
C) changing the money supply does not have any effect on the aggregate price level.
D) aggregate demand is independent from monetary policy.

Use the following to answer question 33.

**Figure: Short-Run Determination of the Interest Rate**

33. (Figure: Short-Run Determination of the Interest Rate) If the money supply is currently at $MS_2$ and the central bank chooses to sell bonds, then the resulting short-run shift in the supply of savings (loanable funds) may be represented by a shift of the:
A) money supply curve to $MS_1$ that lowers the interest rate.
B) supply of loanable funds from $S_1$ to $S_2$ and a lower interest rate.
C) supply of loanable funds from $S_2$ to $S_1$ and a higher interest rate.
D) interest rate from $r_1$ to $r_2$. 
Answer Key - Practice problems Ch.15

1. A
2. C
3. B
4. A
5. B
6. D
7. C
8. A
9. B
10. D
11. B
12. B
13. A
14. B
15. A
16. B
17. B
18. B
19. C
20. B
21. B
22. C
23. C
24. C
25. C
26. A
27. B
28. C
29. B
30. A
31. B
32. A
33. C