Study Guide

Chapter 11 Monetary Policy and Central Bank

1. Central Bank - the Federal Reserve System (the Fed)
2. Money demand (MD)
   - Transactions demand for money - the need to use money as medium of exchange.
   - MD: the negative relationship between interest rate and the quantity money demanded.
   - If price level increases, people have to hold more money to pay bills and buy goods and services. Thus MD increases. The MD curve shifts to the right. Vice versa.
   - If income level increases, people tend to hold more money so that they can spend more. Thus MD increases. The MD curve shifts to the right. Vice versa.
3. Money supply (MS)
   - Money supply is the amount of money circulating in an economy. Money supply is measured by M1 and M2.
   - Money supply is controlled by the Fed.
   - The Fed. Uses **three monetary policies** to control the money supply:

   Policy #1. Open-Market Operation

   a. If the Fed buys government bonds in the open market, MS increases;
   b. If the Fed sells government bonds in the open market, MS decreases.

   Policy #2. Changes in the discount rate

   a. If the Fed decreases the discount rate, MS increases;
   b. If the Fed increases the discount rate, MS decrease.

   Policy #3. Changes in the reserve ratio

   a. If the Fed decreases the reserve ratio, MS increases;
   b. If the Fed increase the reserve ratio, MS decreases.
4. Money market equilibrium
   - Equilibrium interest rate occurs where MD and MS interact.
   - If the Fed wants to raise the equilibrium interest rate, it can increase the MS by buying government bonds in the open market; decrease the discount rate, and/or lower the reserve ratio.

- If the Fed wants to lower the equilibrium interest rate, it can decrease the MS by selling government bonds in the open market; increase the discount rate, and/or raise the reserve ratio.

5. Interest rate, investment, and GDP

- If interest rate is low, firms tends to borrow more money to invest. Investment increases. Vice versa.
- If the Fed wants to increase aggregate demand (AD), it can lower the interest rate (through raising the MS) to stimulate investment.
- If the Fed wants to decrease aggregate demand (AD), it can raise the interest rate by reducing the MS and make investment to drop.

Think: If an economy is in recession, what monetary policy should the Fed apply? If an economy is overheated, what monetary policy should the Fed employ?