Chapter 16
What Should Central Banks Do?
Monetary Policy Goals, Strategy and Tactics

16.1 The Price Stability Goal and the Nominal Anchor

1) The most common definition that central bankers use for price stability is
   A) low and stable deflation.
   B) an inflation rate of zero percent.
   C) high and stable inflation.
   D) low and stable inflation.

Answer: D
Ques Status: New

2) Price stability is desirable because
   A) inflation creates uncertainty, making it difficult to plan for the future.
   B) everyone is better off when prices are stable.
   C) price stability increases the profitability of the Fed.
   D) it guarantees full employment.

Answer: A
Ques Status: Previous Edition

3) Inflation results in
   A) ease of planning for the future.
   B) ease of comparing prices over time.
   C) lower nominal interest rates.
   D) difficulty interpreting relative price movements.

Answer: D
Ques Status: Revised

4) Economists believe that countries recently suffering hyperinflation have experienced
   A) reduced growth.
   B) increased growth.
   C) reduced prices.
   D) lower interest rates.

Answer: A
Ques Status: Revised
5) A nominal variable, such as the inflation rate or the money supply, which ties down the price level to achieve price stability is called ______ anchor.
   A) a nominal
   B) a real
   C) an operating
   D) an intermediate

   Answer: A

   Ques Status: New

6) A central feature of monetary policy strategies in all countries is the use of a nominal variable that monetary policymakers use as an intermediate target to achieve an ultimate goal such as price stability. Such a variable is called a nominal
   A) anchor.
   B) benchmark.
   C) tether.
   D) guideline.

   Answer: A

   Ques Status: Previous Edition

7) A central feature of monetary policy strategies in all countries is the use of a nominal anchor, which is a nominal variable that monetary policymakers use as an
   A) operating target, such as the federal funds interest rate.
   B) intermediate target, such as the federal funds interest rate.
   C) intermediate target to achieve an ultimate goal such as price stability.
   D) operating target to achieve an ultimate goal such as exchange rate stability.

   Answer: C

   Ques Status: Previous Edition

8) A nominal anchor promotes price stability by
   A) outlawing inflation.
   B) stabilizing interest rates.
   C) keeping inflation expectations low.
   D) keeping economic growth low.

   Answer: C

   Ques Status: Revised
9) Monetary policy is considered time-inconsistent because
   
   A) of the lag times associated with the implementation of monetary policy and its effect on
   the economy.

   B) policymakers are tempted to pursue discretionary policy that is more contractionary in
   the short run.

   C) policymakers are tempted to pursue discretionary policy that is more expansionary in
   the short run.

   D) of the lag times associated with the recognition of a potential economic problem and the
   implementation of monetary policy.

   Answer: C

Ques Status: New

10) The time-inconsistency problem with monetary policy tells us that, if policymakers use
    discretionary policy, there is a higher probability that the ______ will be higher, compared to
    policy makers following a behavior rule.

    A) inflation rate
    B) unemployment rate
    C) interest rate
    D) foreign exchange rate

    Answer: A

    Ques Status: New

11) The theory that monetary policy conducted on a discretionary, day-by-day basis leads to poor
    long-run outcomes is referred to as the

    A) adverse selection problem.
    B) moral hazard problem.
    C) time-inconsistency problem.
    D) nominal-anchor problem.

    Answer: C

    Ques Status: Previous Edition

12) The ______ problem of discretionary policy arises because economic behavior is influenced
    by what firms and people expect the monetary authorities to do in the future.

    A) moral hazard
    B) time-inconsistency
    C) nominal-anchor
    D) rational-expectation

    Answer: B

    Ques Status: Previous Edition
13) If the central bank pursues a monetary policy that is more expansionary than what firms and people expect, then the central bank must be trying to
   A) boost output in the short run.
   B) constrain output in the short run.
   C) constrain prices.
   D) boost prices in the short run.
   Answer: A

14) The time-inconsistency problem in monetary policy can occur when the central bank conducts policy
   A) using a nominal anchor.
   B) using a strict and inflexible rule.
   C) on a discretionary, day-by-day basis.
   D) using a flexible, discretionary rule.
   Answer: C

15) Explain the time-inconsistency problem. What is the likely outcome of discretionary policy? What are the solutions to the time-inconsistency problem?
   Answer: With policy discretion, policymakers have an incentive to attempt to increase output by pursuing expansionary policies once expectations are set. The problem is that this policy results not in higher output, but in higher actual and expected inflation. The solution is to adopt a rule to constrain discretion. Nominal anchors can provide the necessary constraint on discretionary behavior.

16.2 Other Goals of Monetary Policy

1) Even if the Fed could completely control the money supply, monetary policy would have critics because
   A) the Fed is asked to achieve many goals, some of which are incompatible with others.
   B) the Fed’s goals do not include high employment, making labor unions a critic of the Fed.
   C) the Fed’s primary goal is exchange rate stability, causing it to ignore domestic economic conditions.
   D) it is required to keep Treasury security prices high.
   Answer: A
2) High unemployment is undesirable because it
   A) results in a loss of output.
   B) always increases inflation.
   C) always increases interest rates.
   D) reduces idle resources.

Answer: A

3) When workers voluntarily leave work while they look for better jobs, the resulting unemployment is called
   A) structural unemployment.
   B) frictional unemployment.
   C) cyclical unemployment.
   D) underemployment.

Answer: B

4) Unemployment resulting from a mismatch of workers' skills and job requirements is called
   A) frictional unemployment.
   B) structural unemployment.
   C) seasonal unemployment.
   D) cyclical unemployment.

Answer: B

5) The goal for high employment should seek a level of unemployment at which the demand for labor equals the supply of labor. Economists call this level of unemployment the
   A) frictional level of unemployment.
   B) structural level of unemployment.
   C) natural rate level of unemployment.
   D) Keynesian rate level of unemployment.

Answer: C
6) Supply-side economic policies seek to
   A) raise interest rates through contractionary monetary policy.
   B) increase federal government expenditures.
   C) increase consumption expenditures by increasing taxes.
   D) increase saving and investment using tax incentives.

   Answer: D
   Ques Status: Revised

7) The Federal Reserve System was created to
   A) make it easier to finance budget deficits.
   B) promote financial market stability.
   C) lower the unemployment rate.
   D) promote rapid economic growth.

   Answer: B
   Ques Status: Revised

8) Having interest rate stability
   A) allows for less uncertainty about future planning.
   B) leads to demands to curtail the Fed's power.
   C) guarantees full employment.
   D) leads to problems in financial markets.

   Answer: A
   Ques Status: Revised

16.3 Should Price Stability Be The Primary Goal of Monetary Policy?

1) Which set of goals can, at times, conflict in the short run?
   A) High employment and economic growth.
   B) Interest rate stability and financial market stability.
   C) High employment and price level stability.
   D) Exchange rate stability and financial market stability.

   Answer: C
   Ques Status: Revised
2) The primary goal of the European Central Bank is
   A) price stability.
   B) exchange rate stability.
   C) interest rate stability.
   D) high employment.

Answer: A
Ques Status: Revised

3) The mandate for the monetary policy goals that has been given to the European Central Bank
is an example of a ________ mandate.
   A) primary
   B) dual
   C) secondary
   D) hierarchical

Answer: D
Ques Status: New

4) The mandate for the monetary policy goals that has been given to the Federal Reserve System
is an example of a ________ mandate.
   A) primary
   B) dual
   C) secondary
   D) hierarchical

Answer: B
Ques Status: New

5) Either a dual or hierarchical mandate is acceptable as long as ________ is the primary goal in
the ________.
   A) price stability; short run
   B) price stability; long run
   C) reducing business-cycle fluctuations; short run
   D) reducing business-cycle fluctuations; long run

Answer: B
Ques Status: New
16.4 Monetary Targeting

1) Under monetary targeting, a central bank announces an annual growth rate target for ________.
   A) a monetary aggregate
   B) a reserve aggregate
   C) the monetary base
   D) GDP
   Answer: A
   Ques Status: New

2) During the years 1979 to 1982, the Federal Reserve’s announced policy was monetary targeting. During this time period the Federal Reserve
   A) hit all of their monetary targets.
   B) did not hit any of their monetary targets because it is believed that controlling the money supply was not the intent of the Federal Reserve.
   C) did not hit any of their monetary targets because they were unrealistic.
   D) hit about half of their monetary targets.
   Answer: B
   Ques Status: New

3) Compared to the United States, Japan’s experience with monetary targeting performed
   A) better with regard to the inflation rate and output fluctuations.
   B) worse with regard to the inflation rate and output fluctuations.
   C) better with regard to the inflation rate, but worse with regard to output fluctuations.
   D) worse with regard to the inflation rate, but better with regard to output fluctuations.
   Answer: A
   Ques Status: New

4) One of the factors that contributed to the success German policymakers had using a monetary targeting type policy was that
   A) they used a rigid target for the money growth rate.
   B) they implemented policy so their inflation rate goal was met in the short run.
   C) the money target was flexible to allow the Bundesbank to concentrate on other goals as needed.
   D) they rarely communicated the intentions of policy to the public in order to keep the public from panicking.
   Answer: C
   Ques Status: New
5) Which of the following is an advantage to money targeting?
   A) There is an immediate signal on the achievement of the target.
   B) It does not rely on a stable money–inflation relationship.
   C) It implies lack of transparency.
   D) It implies smaller output fluctuations.

   Answer: A
   Ques Status: New

6) Which of the following is a disadvantage to monetary targeting?
   A) It relies on a stable money–inflation relationship.
   B) There is a delayed signal about the achievement of a target.
   C) It implies larger output fluctuations.
   D) It implies a lack of transparency.

   Answer: A
   Ques Status: New

7) If the relationship between the monetary aggregate and the goal variable is weak, then
   A) monetary aggregate targeting is superior to exchange–rate targeting.
   B) monetary aggregate targeting is superior to inflation targeting.
   C) inflation targeting is superior to exchange–rate targeting.
   D) monetary aggregate targeting will not work.

   Answer: D
   Ques Status: Revised

8) The monetary policy strategy that provides an immediate signal on target achievement is
   A) exchange–rate targeting.
   B) monetary targeting.
   C) inflation targeting.
   D) the implicit nominal anchor.

   Answer: B
   Ques Status: Revised
9) The monetary policy strategy that relies on a stable money-income relationship is
   A) exchange-rate targeting.
   B) monetary targeting.
   C) inflation targeting.
   D) the implicit nominal anchor.
   Answer: B
   Ques Status: Revised

16.5 Inflation Targeting

1) The type of monetary policy that is used in Canada, New Zealand, and the United Kingdom is
   A) monetary targeting.
   B) inflation targeting.
   C) targeting with an implicit nominal anchor.
   D) interest-rate targeting.
   Answer: B
   Ques Status: New

2) Which of the following is not an element of inflation targeting?
   A) A public announcement of medium-term numerical targets for inflation
   B) An institutional commitment to price stability as the primary long-run goal
   C) An information-inclusive approach in which only monetary aggregates are used in making decisions about monetary policy
   D) Increased accountability of the central bank for attaining its inflation objectives
   Answer: C
   Ques Status: New

3) The first country to adopt inflation targeting was
   A) the United Kingdom.
   B) Canada.
   C) New Zealand.
   D) Australia.
   Answer: C
   Ques Status: New
4) In both New Zealand and Canada, what has happened to the unemployment rate since the countries adopted inflation targeting?
   A) The unemployment rate increased sharply.
   B) The unemployment rate remained constant.
   C) The unemployment rate has declined substantially after a sharp increase.
   D) The unemployment rate declined sharply immediately after the inflation targets were adopted.

   Answer: C
   Ques Status: New

5) Which of the following is not an advantage of inflation targeting?
   A) There is simplicity and clarity of the target.
   B) Inflation targeting does not rely on a stable money–inflation relationship.
   C) There is an immediate signal on the achievement of the target.
   D) Inflation targeting reduces the effects of inflation shocks.

   Answer: C
   Ques Status: New

6) Which of the following is not a disadvantage to inflation targeting?
   A) There is a delayed signal about achievement of the target.
   B) Inflation targets could impose a rigid rule on policymakers.
   C) There is potential for larger output fluctuations.
   D) There is a lack of transparency.

   Answer: D
   Ques Status: New

7) The decision by inflation targeters to choose inflation targets _______ zero reflects the concern of monetary policymakers that particularly _______ inflation can have substantial negative effects on real economic activity.
   A) below; high
   B) below; low
   C) above; high
   D) above; low

   Answer: D
   Ques Status: Previous Edition
8) Inflation targets can increase the central bank’s flexibility in responding to declines in aggregate spending. Declines in aggregate _______ that cause the inflation rate to fall below the floor of the target range will automatically stimulate the central bank to ________ monetary policy without fearing that this action will trigger a rise in inflation expectations.

A) demand: tighten
B) demand: loosen
C) supply: tighten
D) supply: loosen

Answer: B

Ques Status: Previous Edition

9) Explain what inflation targeting is. What are the advantages and disadvantages of this type of monetary policy strategy?

Answer: There are five main elements to inflation targeting: 1. a public announcement of a medium-term target for the inflation rate; 2. a commitment to price stability as the primary long-term goal of policy; 3. many variables are used in making decisions about policy moves; 4. increased transparency about policy strategy with the public; 5. the central bank has increased accountability for attaining policy goals.

The advantages of inflation targeting include: 1. the simplicity and clarity of a numerical target for the inflation rate; 2. does not rely on a stable money–inflation relationship; 3. there is increased accountability of the central bank; 4. reduces the effects of inflationary shocks.

The disadvantages of inflation targeting include: 1. there is a delayed signal about the achievement of the target; 2. it could lead to a rigid rule where the only focus is the inflation rate (has not happened in practice); 3. if sole focus is the inflation rate, larger output fluctuations can occur (has not happened in practice).

Ques Status: New

16.6 Monetary Policy with an Implicit Nominal Anchor

1) The type of monetary policy regime that the Federal Reserve has been following in recent years can best be described as

A) monetary targeting.
B) inflation targeting.
C) policy with an implicit nominal anchor.
D) exchange-rate targeting.

Answer: C

Ques Status: New
2) Estimates suggest that, in the United States economy, it takes just over _______ for monetary policy to affect output and just over _______ for monetary policy to affect the inflation rate.
   A) 1 year; 2 years
   B) 2 years; 1 year
   C) 1 year; 6 months
   D) 6 months; 1 year
   Answer: A
   Ques Status: New

3) Which of the following is an advantage of using an implicit nominal anchor for monetary policy?
   A) It does not rely on the money–inflation relationship.
   B) It is simplistic and has clarity.
   C) There is increased accountability of central bankers.
   D) There is an immediate signal if the target has been achieved.
   Answer: A
   Ques Status: New

4) Which of the following is not a disadvantage of using an implicit nominal anchor for monetary policy?
   A) There is low transparency of policy.
   B) There is low accountability for central bankers.
   C) This type of policy relies on the policy-makers in charge.
   D) It relies on a stable money–inflation relationship.
   Answer: D
   Ques Status: New

5) When compared to the Fed’s _______ anchor approach, _______ targeting can make the institutional framework for the conduct of monetary policy more consistent with democratic principles.
   A) nominal; inflation
   B) implicit; monetary
   C) nominal; monetary
   D) implicit; inflation
   Answer: D
   Ques Status: Previous Edition
6) The monetary policy strategy that suffers a lack of transparency is
   A) exchange-rate targeting.
   B) monetary targeting.
   C) inflation targeting.
   D) the implicit nominal anchor.

   Answer: D
   Ques Status: Revised

7) The monetary policy strategy that provides the least accountability is
   A) exchange-rate targeting.
   B) monetary targeting.
   C) inflation targeting.
   D) the implicit nominal anchor.

   Answer: D
   Ques Status: Revised

8) Explain the type of monetary policy strategy that the Federal Reserve has used in recent years. What are the advantages and disadvantages to this type of strategy?

   Answer: The Federal Reserve doesn’t use an explicit nominal anchor such as a monetary aggregate or the inflation rate. Its strategy revolves around using an implicit nominal anchor in the form of an overriding concern to control inflation in the long run. This involves forward-looking behavior and “pre-emptive strikes” by policy actions to prevent inflation. This forward-looking behavior is necessary because of the long time lags between monetary policy action and its impact on inflation.

   The advantages of this policy strategy include: 1. it doesn’t rely on a stable money-inflation relationship; 2. the demonstrated success it had in the United States.

   The disadvantages of this policy strategy include: 1. there is a lack of transparency; 2. its success depends on the individuals in charge of policy; 3. there is low accountability of the central bank.

   Ques Status: New

16.7 Tactics: Choosing the Policy Instrument

1) Which of the following is not an operating instrument?
   A) Nonborrowed reserves
   B) Monetary base
   C) Federal funds interest rate
   D) Discount rate

   Answer: D
   Ques Status: Revised
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2) Which of the following is a potential operating instrument for the central bank?
   A) The monetary base
   B) The M1 money supply
   C) Nominal GDP
   D) The discount rate

Answer: A
   Ques Status: Revised

3) Due to the lack of timely data for the price level and economic growth, the Fed’s strategy
   A) targets the exchange rate, since the Fed can control this variable.
   B) targets the price of gold, since it is closely related to economic activity.
   C) uses an intermediate target, such as an interest rate.
   D) stabilizes the consumer price index, since the Fed can control the CPI.

Answer: C
   Ques Status: Revised

4) If the central bank targets a monetary aggregate, it is likely to lose control over the interest rate Because
   A) of fluctuations in the demand for reserves.
   B) of fluctuations in the consumption function.
   C) bond values will tend to remain stable.
   D) of fluctuations in the business cycle.

Answer: A
   Ques Status: Revised

5) If the Fed pursues a strategy of targeting an interest rate when fluctuations in money demand are prevalent,
   A) fluctuations of nonborrowed reserves will be small.
   B) fluctuations of nonborrowed reserves will be large.
   C) the Fed will probably quickly abandon this policy, as it did in the 1960s.
   D) the Fed will probably quickly abandon this policy, as it did in the 1950s.

Answer: B
   Ques Status: Revised
6) Fluctuations in the demand for reserves cause the Fed to lose control over a monetary aggregate if the Fed targets
   A) a monetary aggregate.
   B) the monetary base.
   C) an interest rate.
   D) nominal GDP.
   Answer: C
   *Ques Status: Revised*

7) Interest rates are difficult to measure because
   A) data on them are not available in a timely manner.
   B) real interest rates depend on the hard-to-determine expected inflation rate.
   C) they fluctuate too often to be accurate.
   D) they cannot be controlled by the Fed.
   Answer: B
   *Ques Status: Revised*

8) Which of the following criteria need not be satisfied for choosing an intermediate target?
   A) The variable must be measurable.
   B) The variable must be controllable.
   C) The variable must be predictable.
   D) The variable must be transportable.
   Answer: D
   *Ques Status: Previous Edition*

9) Which of the following is not a requirement in selecting an intermediate target?
   A) Measurability
   B) Controllability
   C) Flexibility
   D) Predictability
   Answer: C
   *Ques Status: Previous Edition*
10) When it comes to choosing an policy instrument, both the ______ rate and ______ aggregates are measured accurately and are available daily with almost no delay.

   A) three-month T-bill; monetary
   B) three-month T-bill; reserve
   C) federal funds; monetary
   D) federal funds; reserve

Answer: D
Ques Status: Revised

11) If the desired intermediate target is an interest rate, then the preferred policy instrument will be a(n) ______ variable like the ______.

   A) interest rate; three-month T-bill rate
   B) interest rate; federal funds rate
   C) monetary aggregate; monetary base
   D) monetary aggregate; nonborrowed base

Answer: B
Ques Status: Revised

12) If the desired intermediate target is a monetary aggregate, then the preferred policy instrument will be a(n) ______ variable like the ______.

   A) interest rate; three-month T-bill rate
   B) interest rate; federal funds rate
   C) reserve aggregate; monetary base
   D) reserve aggregate; narrow money supply M1

Answer: C
Ques Status: Revised

13) If the desired intermediate target is a monetary aggregate, which of the following would be the most preferred policy instrument?

   A) The federal funds rate
   B) The 90-day T-bill rate
   C) The 180-day T-bill rate
   D) The monetary base

Answer: D
Ques Status: Revised
14) If the desired intermediate target is an interest rate, the preferred policy instrument would be

A) the federal funds rate.
B) the monetary base.
C) nonborrowed reserves.
D) borrowed reserves.
E) the discount rate.

Answer: A

Ques Status: Revised

15) Explain and demonstrate graphically how targeting nonborrowed reserves can result in federal funds rate instability.

Answer: See figure below.

![Diagram](image)

When nonborrowed reserves are held constant, increases in the demand for reserves result in the federal funds rate increasing and decreases in the demand for nonborrowed reserves result in the federal funds rate declining. Since fluctuations in demand do not cause monetary policy actions, the result is the federal funds rate will fluctuate (assuming the equilibrium federal funds rate is below the discount rate).

Ques Status: Revised
16) Explain and demonstrate graphically how targeting the federal funds rate can result in fluctuations in nonborrowed reserves.

Answer: See figure below.

![Diagram showing federal funds rate and nonborrowed reserves]

With a federal funds rate target, fluctuations in demand for reserves require similar changes in the nonborrowed reserves to keep the federal funds rate constant.

Ques Status: Revised

16.8 The Taylor Rule, NAIRU and the Philips Curve

1) According to the Taylor rule, the Fed should raise the federal funds interest rate when inflation ______ the Fed’s inflation target or when real GDP ______ the Fed’s output target.

A) rises above; drops below
B) drops below; drops below
C) rises above; rises above
D) drops below; rises above

Answer: C
Ques Status: Revised

2) Using Taylor’s rule, when the equilibrium real federal funds rate is 3 percent, the positive output gap is 2 percent, the target inflation rate is 1 percent, and the actual inflation rate is 2 percent, the nominal federal funds rate target should be

A) 5 percent.
B) 5.5 percent.
C) 6 percent.
D) 6.5 percent.

Answer: D
Ques Status: Revised
3) Using Taylor’s rule, when the equilibrium real federal funds rate is 2 percent, there is no output gap, the actual inflation rate is zero, and the target inflation rate is 2 percent, the nominal federal funds rate should be
   A) 0 percent.
   B) 1 percent.
   C) 2 percent.
   D) 3 percent.

Answer: B

Ques Status: Revised

4) The rate of inflation tends to remain constant when
   A) the unemployment rate is above the NAIRU.
   B) the unemployment rate equals the NAIRU.
   C) the unemployment rate is below the NAIRU.
   D) the unemployment rate increases faster than the NAIRU increases.

Answer: B

Ques Status: Revised

5) The rate of inflation increases when
   A) the unemployment rate equals the NAIRU.
   B) the unemployment rate exceeds the NAIRU.
   C) the unemployment rate is less than the NAIRU.
   D) the unemployment rate increases faster than the NAIRU increases.

Answer: C

Ques Status: Revised
6) Explain the Taylor rule, including the formula for setting the federal funds rate target, and the components of the formula. If the Fed were to use this rule, how many goals would it use to set monetary policy?

Answer: The Taylor rule specifies that the target federal fund rates should be set to equal the equilibrium real federal funds rate, plus the rate of inflation (for the Fisher effect), plus one-half times the output gap, plus one-half times the inflation gap. The formula is

\[
\text{Federal funds rate target} = \text{equilibrium real federal funds rate} + \text{inflation rate} + \frac{1}{2} \text{(output gap)} + \frac{1}{2} \text{(inflation gap)}
\]

The output gap is the percentage deviation of real GDP from potential full-employment real GDP. The inflation gap is the difference between actual inflation and the central bank’s target rate of inflation. The equilibrium real federal funds rate is the real rate consistent with full employment in the long run. The inflation rate is the actual rate of inflation. The Taylor rule sets the federal funds rate recognizing the goals of low inflation and full employment (or equilibrium long-run economic growth).

Ques Status: Previous Edition

16.9 Appendix: Fed Policy Procedures: Historical Perspective

1) In its earliest years, the Federal Reserve’s guiding principle for the conduct of monetary policy was known as the

A) real bills doctrine.
B) liberal liquidity doctrine.
C) free reserves doctrine.
D) quantity theory of money.

Answer: A
Ques Status: Revised

2) The guiding principle for the conduct of monetary policy that held that as long as loans were being made for “productive” purposes, then providing reserves to the banking system to make these loans would not be inflationary became known as the

A) free reserves doctrine.
B) Benjamin Strong doctrine.
C) efficient liquidity doctrine.
D) real bills doctrine.

Answer: D
Ques Status: Previous Edition
3) The real bills doctrine was the guiding principle for the conduct of monetary policy during the
   A) 1910s.
   B) 1940s.
   C) 1950s.
   D) 1960s.
   Answer: A

4) The Fed accidentally discovered open market operations in the early
   A) 1920s.
   B) 1910s.
   C) 1900s.
   D) 1890s.
   Answer: A

5) The Fed accidentally discovered open market operations when
   A) it came to the rescue of failing banks in the early 1930s, and found that its purchases of bank loans injected reserves into the banking system.
   B) it purchased securities for income following the 1920–1921 recession.
   C) it attempted to slow inflation in 1919 by selling securities and found that its sales drained reserves from the banking system.
   D) it reinterpreted a key provision of the Federal Reserve Act.
   Answer: B

6) The Fed’s mistakes of the early 1930s were compounded by its decision to
   A) raise reserve requirements in 1936–1937.
   B) lower reserve requirements in 1936–1937.
   C) raise the monetary base in 1936–1937.
   D) lower the monetary base in 1936–1937.
   Answer: A
7) During World War II, whenever interest rates would _______ and the price of bonds would begin to _______, the Fed would make open market purchases.

A) rise; rise
B) rise; fall
C) fall; rise
D) fall; fall

Answer: B
Ques Status: Previous Edition

8) During World War II, whenever interest rates would rise and the price of bonds would begin to fall, the Fed would

A) lower reserve requirements.
B) raise reserve requirements.
C) make open market purchases of government securities.
D) make open market sales of government securities.

Answer: C
Ques Status: Previous Edition

9) During World War II, the Fed in effect relinquished its control of monetary policy through its policy of

A) continually lowering reserve requirements.
B) continually raising reserve requirements.
C) pegging interest rates.
D) targeting free reserves.

Answer: C
Ques Status: Previous Edition

10) The Fed was committed to keeping interest rates low to assist Treasury financing of budget deficits

A) only during World War I.
B) during the Great Depression.
C) during World War I and World War II.
D) throughout the entire existence of the Fed.

Answer: C
Ques Status: Revised
11) The Fed–Treasury Accord of March 1951 provided the Fed greater freedom to
   A) let interest rates increase.
   B) let unemployment increase.
   C) let inflation accelerate.
   D) let exchange rates increase.

   Answer: A
   Ques Status: Revised

12) During the 1950s, the Fed targeted
   A) M1.
   B) M2.
   C) the monetary base.
   D) money market conditions.

   Answer: D
   Ques Status: Revised

13) During the 1950s, Fed monetary policy targeted
   A) the monetary base.
   B) the exchange rate.
   C) discount loans.
   D) interest rates.

   Answer: D
   Ques Status: Revised

14) Targeting interest rates can be procyclical because
   A) an increase in income increases interest rates, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.
   B) an increase in interest rates increases income, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.
   C) an increase in the monetary base increases the money supply, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.
   D) an increase in income increases the monetary base and money supply, causing the Fed to buy bonds to increase interest rates and income.

   Answer: A
   Ques Status: Revised
15) High inflation can spiral out of control when

A) expected inflation increases nominal interest rates, causing the Fed to buy bonds, increasing the money supply and further increasing inflation.

B) expected inflation decreases nominal interest rates, causing the Fed to buy bonds, increasing the money supply and further increasing inflation.

C) expected inflation increases nominal interest rates, causing the Fed to sell bonds, increasing the money supply and further increasing inflation.

D) expected inflation decreases nominal interest rates, causing the Fed to sell bonds, increasing the money supply and further increasing inflation.

Answer: A

Ques Status: Revised

16) In practice, the Fed’s policy of targeting money market conditions in the 1960s proved to be

A) countercyclical, helping to stabilize the economy.

B) procyclical, destabilizing the economy.

C) procyclical, helping to stabilize the economy.

D) countercyclical, destabilizing the economy.

Answer: B

Ques Status: Previous Edition

17) In practice, the Fed’s policy of targeting _______ in the 1960s proved to be _______. destabilizing the economy.

A) money market conditions; countercyclical

B) money market conditions; procyclical

C) monetary aggregates; countercyclical

D) monetary aggregates; procyclical

Answer: B

Ques Status: Previous Edition

18) Although the Fed professed employment of a monetary aggregate targeting strategy during the 1970s, its behavior suggests that it emphasized

A) free-reserve targeting.

B) interest-rate targeting.

C) a real-bills doctrine.

D) price-index targeting.

Answer: B

Ques Status: Previous Edition
19) Although the Fed professed employment of ________ targeting during the 1970s, its behavior suggests that it emphasized ________ targeting.
   A) free-reserve; interest-rate
   B) interest-rate; monetary aggregate
   C) monetary aggregate; interest-rate
   D) free reserve; monetary aggregate

Answer: C  
Ques Status: Revised

20) The Fed’s use of the federal funds rate as an operating target in the 1970s resulted in
   A) countercyclical monetary policy.
   B) too slow growth in M1 throughout the decade.
   C) procyclical monetary policy.
   D) too rapid growth in M1 throughout the decade.

Answer: C  
Ques Status: Revised

21) The Fed’s use of the ________ as an operating target in the 1970s resulted in ________ monetary policy.
   A) federal funds rate; countercyclical
   B) federal funds rate; procyclical
   C) M1 money supply; countercyclical
   D) M1 money supply; procyclical

Answer: B  
Ques Status: Revised

22) In the 1970s, the Fed selected an interest rate as an operating target rather than a reserve aggregate primarily because it
   A) had no interest in targeting a monetary aggregate, as evidenced by its unwillingness to target a reserve aggregate.
   B) was still very concerned with achieving interest rate stability.
   C) was committed to targeting free reserves.
   D) was committed to the real bills doctrine.

Answer: B  
Ques Status: Previous Edition
23) The Fed operating procedures employed between 1979 and 1982 resulted in _______ swings in the federal funds rate and _______ swings in the M1 growth rate.

A) increased; increased  
B) increased; decreased  
C) decreased; decreased  
D) decreased; increased

Answer: A

24) The fluctuations in both money supply growth and the federal funds rate during 1979–1982 suggest that the Fed

A) had shifted to borrowed reserves as an operating target.  
B) had shifted to total reserves as an operating target.  
C) had shifted to the monetary base as an operating target.  
D) never intended to target monetary aggregates.

Answer: D

25) The Fed’s failure to exercise effective control over the money supply during the 1979–1982 period

A) proves that such control is not possible.  
B) resulted because forces outside of its control removed the link between open market operations and the money supply.  
C) occurred despite evidence of a strong link between open market operations and the money supply.  
D) stems from the Treasury–Federal Reserve Accord.

Answer: C

26) Large fluctuations in money supply growth and smaller fluctuations in the federal funds rate between October 1982 and the early 1990s indicate that the Fed had shifted to _______ as an operating target.

A) borrowed reserves  
B) nonborrowed reserves  
C) excess reserves  
D) required reserves

Answer: A
27) The strengthening of the dollar between 1980 and 1985 contributed to a _______ in American competitiveness, putting pressure on the Fed to pursue a more _______ monetary policy.

   A) decrease; contractionary  
   B) increase; expansionary  
   C) increase; contractionary  
   D) decrease; expansionary  

   Answer: D
   *Ques Status: Revised*

28) A borrowed reserves target is _______ because increases in income _______ interest rates and discount loans, causing the Fed to _______ the monetary base, everything else held constant.

   A) procyclical; increase; increase  
   B) countercyclical; increase; increase  
   C) procyclical; reduce; reduce  
   D) countercyclical; reduce; reduce  

   Answer: A
   *Ques Status: Revised*

29) Fed policy since the early 1990s indicates that it is pursuing a policy of targeting the

   A) monetary base.  
   B) money supply.  
   C) federal funds interest rate.  
   D) exchange rate.

   Answer: C
   *Ques Status: Previous Edition*

30) Since the early 1990s, the Fed has conducted monetary policy by setting a target for the

   A) level of borrowed reserves.  
   B) monetary base.  
   C) federal funds rate.  
   D) inflation rate.

   Answer: C
   *Ques Status: Revised*
31) The Fed can engage in preemptive strikes against a rise in inflation by _______ the federal funds interest rate; it can act preemptively against negative demand shocks by _______ the federal funds interest rate.

A) raising; lowering
B) raising; raising
C) lowering; lowering
D) lowering; raising

Answer: A

Ques Status: Previous Edition

32) International policy coordination refers to

A) central banks in major nations acting without regard to the global consequences of their policies.
B) central banks in major nations pursuing only domestic objectives.
C) central banks adopting policies in pursuit of joint objectives.
D) central banks all adopting identical policies.

Answer: C

Ques Status: Revised