The three basic monetary tools of the central bank:

________________________ is the minimum fraction of deposits that commercial banks are required to keep as reserves.

________________________ is the interest rate that the central bank charges when it lends money to commercial banks.

________________________ refer to the purchase and sale of government bonds by the central bank to regulate the money supply.

What is contractionary monetary policy?

a) It is a series of possible measures taken by central banks in order to do what about money supply and interest rates?
   It is a series of possible measures taken by central banks in order to ________________
   ____

b) Why is it contractionary in the short run?
   It is contractionary because ____
   ____

How can the central bank reduce the money supply using the three monetary tools?

1. The central bank can ____
2. The central bank can ____
3. The central bank can ____

The process of the effects of the contractionary policy on the economy:

Step 1: The contractionary monetary policy adopted by the central bank

Step 2: What will happen to the money supply?

____

Step 3: What will happen to the interest rates, both nominal and real?

____

Step 4: What will happen to real consumption and investment?

____

Step 5: What will happen to the aggregate demand?

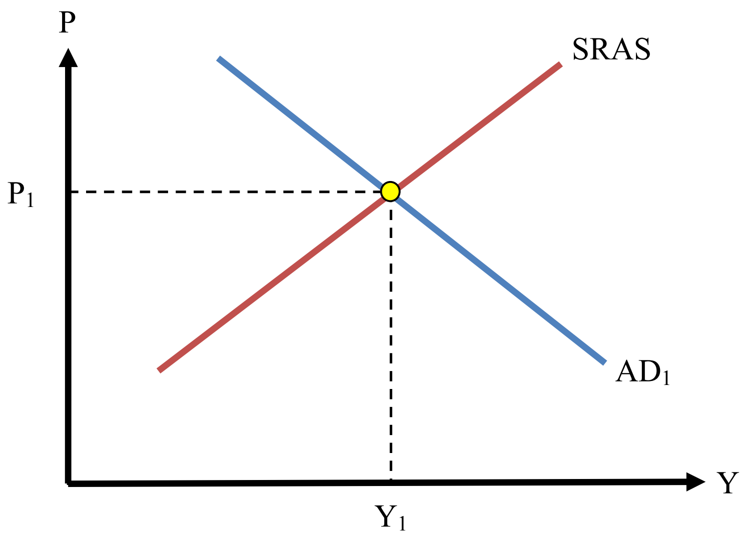
____

Step 6: What will happen to the general price level and the real output level?

____

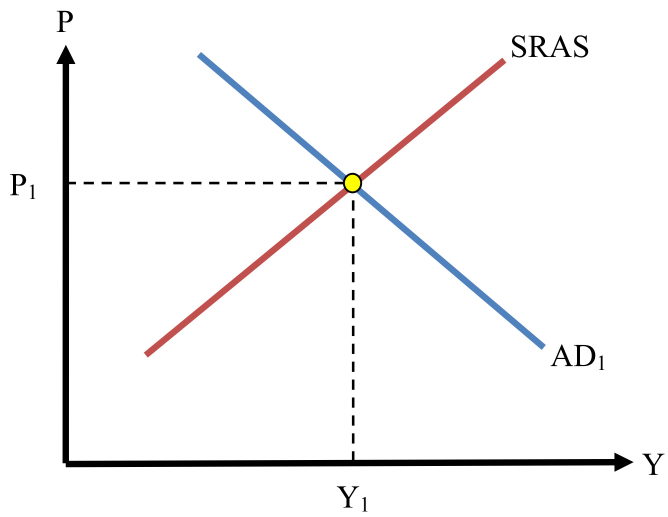
1. Explain the effects of an increase in required reserve ratio (rrr) on the aggregate output and price level with the aid of an AD-AS diagram.

Step 1:
Step 2:
Step 3:
Step 4:
Step 5:
Step 6:

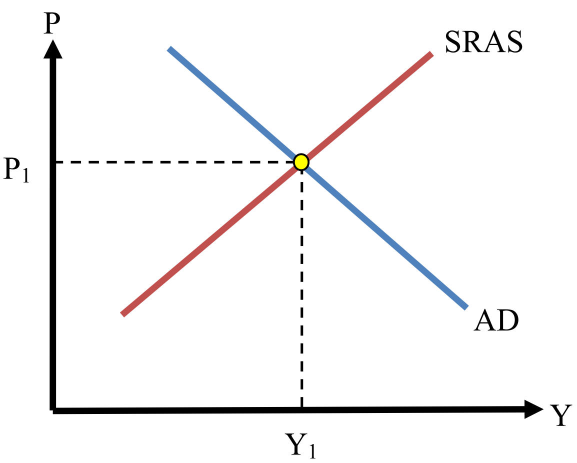
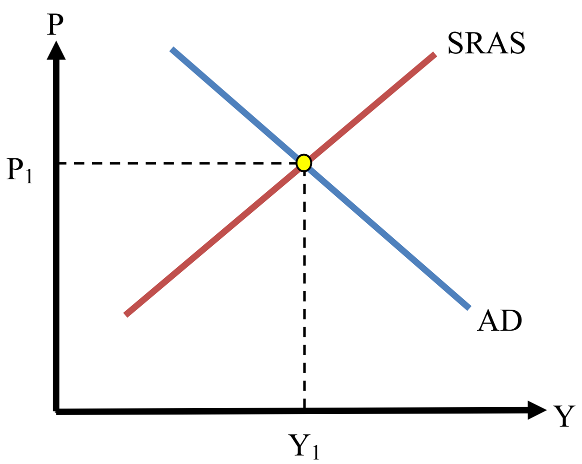


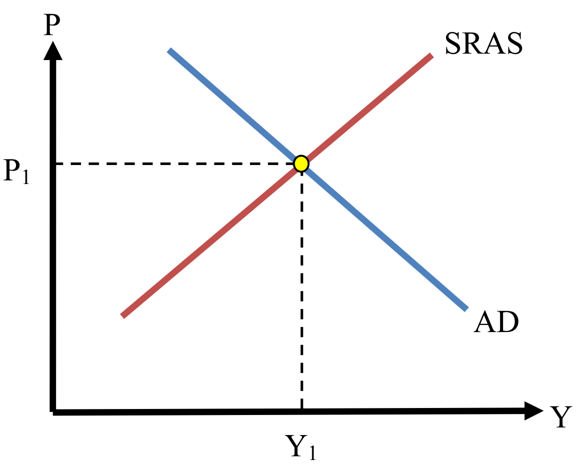
2. What would be the short run effects of an increase in discount rate on the price levels and output levels of the economy? Explain your answer with the aid of an AD-AS diagram.

Step 1:
Step 2:
Step 3:
Step 4:
Step 5:
Step 6:



What would happen when the central bank adopts contractionary monetary policy in the following cases? Can it help to achieve the long run equilibrium? If no, write down what gap it would result.
Please draw the LRAS curve in the appropriate places.

Initial condition: Inflationary gap	Initial condition: Deflationary gap
	
Yes/ No.	Yes/ No.

Initial condition: Full employment

Yes/ No.

Macroeconomics Ch. 10
Contractionary monetary policy
Past Exam Exercise

(HKDSE 2014-II Q.12) The Prime Minister of Japan, Shinzō Abe, adopted a series of policy measures in 2013 to expand the Japanese economy. One of the policy measures was stepping up the scale of the purchase of government bonds and other financial assets by the central bank.

c) What would be the short run effects of the above policy on the output and price levels of the Japanese economy? Explain your answer with the aid of an aggregate-supply-aggregate-demand diagram. (8 marks)