**PB202 MACROECONOMICS**

**END OF CHAPTER**

**Answer the question below.**

There are various instruments or tools of monetary policy which Central Bank employs to achieve the goals of the economy policy. These instruments will implement based on the economic condition. Discuss in the group the tools in monetary policy that may taken by Central Bank during inflation.

 **(10 marks)**

**Answer:**

During inflation, Central Bank implements Contractionary Monetary Policy to decrease the money supply in the economy during inflation. **(1mark)**

The tools of Monetary Policy:

1. **Open Market Operation** **(1mark)**

The most effective instruments where Central Bank can influence the cash reserve of commercial banks. **(1 mark)**

During inflation, Central Bank will reduce reserve in the banking system by selling the government securities to the banking system. This will lead a reduction of money supply in banking system. **(1mark)**

1. **Discount rate** **(1 mark)**

Discount rate or bank rate is the rate of interest charge by Central Bank to Commercial bank. If commercial banks want to make a loan from reserve in Central Bank, they have to pay this interest rate as a cost of borrowing. **(1 mark)**

Raising the discount rate discourages banks from borrowing reserves from Central Bank and contracts the money supply. Therefore, during inflation the best choice is increase discount rate to decrease the money supply in the economy. **(1 mark)**

1. **Reserve requirement ratio**  **(1 mark)**

Banking institutions namely commercial banks, merchant/investment banks and Islamic banks are required to maintain balances in the reserve requirement account base on the reserve requirement rate. **(1 mark)**

Through this tool, central Bank can control banking system liquidity and credit creation. By increasing the ratio, banking sector will have less ability to lend thus reduced money supply in the economy. **(1mark)**