LO.a: Compare monetary and fiscal policy.

1. Two analysts make the following statements:
   Analyst 1: Monetary policy seeks to influence the macro economy by influencing the quantity of money and credit in the economy. On the other hand, fiscal policy involves the use of government spending and taxation to influence economic activity.
   Analyst 2: Fiscal policy seeks to influence the macro economy by influencing the quantity of money and credit in the economy. On the other hand, monetary policy involves the use of government spending and taxation to influence economic activity.
   Which analyst is *most likely* correct?
   A. Analyst 1.
   B. Analyst 2.
   C. Neither.

2. Which of the following is *most likely* to be a goal of fiscal policy?
   A. Influencing credit in the economy.
   B. Redistribution of wealth and income.
   C. Using taxes to influence economic activity.

LO.b: Describe functions and definitions of money.

3. To fulfill its role as a medium of exchange, money should *least likely*:
   A. have a known value.
   B. have a low value relative to its weight.
   C. be easily divisible.

4. Money is used to buy goods and services, does not perish physically, and defines the price of goods and services. The *most appropriate* terms for these functions of money are:
   A. medium of exchange, unit of account and store of wealth respectively.
   B. unit of account, medium of exchange and store of value respectively.
   C. medium of exchange, store of wealth and unit of account respectively.

5. The term used to describe notes and coins in circulation in an economy, plus other very highly liquid deposits is *most likely*:
   A. Broad money.
   B. Narrow money.
   C. Bank money.

6. To act as a liberating medium of exchange, money should *least likely* be:
   A. Easily divisible.
   B. Easy to counterfeit.
   C. High value relative to weight.

LO.c: Explain the money creation process.

7. If the reserve requirement for banks in an economy is 8%, the total money created from a deposit of $100 into an account is *closest* to:
   A. $800.
   B. $1,050.
   C. $1,250.

8. Given that the reserve requirement in an economy is 10 percent for banks, how much money can be created with a deposit of $200?
   A. $220.
   B. $1,800.
   C. $2,000.

LO.d: Describe theories of the demand for and supply of money.

9. The speculative demand for money refers to the demand to hold money:
   A. to use in the purchase of goods and services.
   B. as a buffer against unforeseen events.
   C. based on the opportunity or risks inherent in other financial instruments.

10. If the expected return on other assets fall, the speculative demand for money will:
   A. increase.
   B. decrease.
   C. remain unaffected.

11. A contraction in the money supply would *most likely*:
   A. lead to an increase in nominal interest rates.
   B. lead to a decrease in nominal interest rates.
   C. increase the equilibrium amount of money that economic agents would wish to hold.

12. As the gross domestic product (GDP) grows over time:
   A. transactions money balances increase and precautionary money balances decrease.
   B. transactions money balances decrease and precautionary money balances increase.
   C. both transactions and precautionary money balance increase.

13. Which of the following is *most likely* correct about the quantity equation of exchange?
   A. The velocity of money is assumed to be approximately constant.
   B. The spending, P * V, is approximately proportional to quantity of money, M.
   C. If money neutrality holds, an increase in the money supply, M, affects Y, real output.

14. Money balances held based on the potential opportunities or risks of other financial instruments are known as:
   A. transactions money balances.
   B. precautionary money balances.
   C. speculative money balances.

LO.e: Describe the Fisher effect.

15. According to the Fischer effect, a decrease in expected inflation will *most likely* decrease:
    A. both nominal and real interest rates.
    B. the nominal interest rate.
    C. the real interest rate.

16. Nominal interest rate *least likely* comprises:
    A. Real Interest rate.
    B. Actual Inflation.
    C. Risk premium.

LO.f: Describe roles and objectives of central banks.

17. The main long-run objective of most central banks is:
    A. fast economic growth.
    B. price stability.
    C. current account surplus.

18. The following table lists some responsibilities:

	Responsibility
i	Conductor of monetary policy
ii	Lender of last resort
iii	Monopoly supplier of currency
iv	Supervisor of payments system

    Which of the above *most likely* include the responsibilities of a central bank?
    A. i and ii.
    B. i, ii and iii.
    C. All of them.

LO.g: Contrast the costs of expected and unexpected inflation.

19. Due to high inflation, businesses constantly have to change the advertised prices of their goods and services. This is *best* described as:
    A. menu costs.
    B. shoe leather costs.
    C. inflation uncertainty.

20. Unexpected inflation *least likely*:
    A. leads to inequitable transfers of wealth between borrowers and lenders.
    B. gives rise to risk premia in borrowing rates and the prices of other assets.
    C. increases the information content of market prices.

21. Which of the following is *least likely* a cost associated with expected inflation?
    A. Demand costs.
    B. Menu costs.

C. Shoe leather costs.

LO.h: Describe tools used to implement monetary policy.

22. If a central bank announces an increase in its official interest rate, the money supply will *most likely*:
    A. increase.
    B. decrease.
    C. remain unaffected.

23. Assume that the central bank increases the reserve requirement. The *most likely* effect will be:
    A. a decrease in the money multiplier.
    B. an increase in the money supply.
    C. an increase in new deposits.

24. According to the monetary transmission mechanism, implementation of the monetary policy is *most likely* to work through the economy via:
    A. bank lending rates.
    B. exchange rates.
    C. both bank lending rates and exchange rates.

LO.i: Describe the monetary transmission mechanism.

25. A change in a central bank's policy rate will affect:
    A. asset prices only.
    B. expectations about future interest rates only.
    C. both asset prices and expectations about future interest rates.

26. Suppose that a central bank announces an increase in its official interest rate. What is the *most likely* effect of this announcement on inflation?
    A. Upward pressure on inflation.
    B. Downward pressure on inflation.
    C. No effect on inflation.

LO.j: Describe qualities of effective central banks.

27. The credibility of a central bank is important because:
    A. it is the lender of last resort.
    B. its targets can become self-fulfilling prophecies.
    C. it is the monopolistic suppliers of the currency.

28. A central bank determines the definition of inflation that it targets, the rate of inflation that it targets, and the horizon over which the target is to be achieved. It also decides the level of interest rates. The central bank is:
    A. operationally independent.

B. target independent.
C. both operationally and target independent.

29. The central bank in Sweden is tasked to hit a level of inflation determined by the government. This bank is *most likely* to be:
    A. operationally independent, but not target independent.
    B. target independent, but not operationally independent.
    C. Both operationally and target independent.

LO.k: Explain the relationships between monetary policy and economic growth, inflation, interest, and exchange rates.

30. If a central bank increases the money supply, this move will *most likely* lead to a:
    A. decline in nominal interest rates and a rise in aggregate price level.
    B. rise in nominal interest rate and a decline in aggregate price level.
    C. decline in nominal interest rates and decline in aggregate price level.

31. A decrease in a central bank's policy rate might be expected to increase inflationary pressure by:
    A. increasing consumer demand.
    B. increasing the foreign exchange value of the currency.
    C. driving down asset prices leading to a decrease in personal sector wealth.

32. An increase in the growth rate of money supply will:
    A. cause the domestic currency to appreciate relative to those of the country's trading partners.
    B. cause the domestic currency to depreciate relative to those of the country's trading partners.
    C. will have no effect on the exchange rate.

33. Demand shocks are a rise in inflation caused by:
    A. an increase in the cost of production.
    B. an increase in investment growth rates.
    C. a decline in consumers' confidence.

34. When the demand for money is infinitely elastic, further injections of money into the economy fails to affect real activity. This is known as:
    A. Bond market vigilante.
    B. Liquidity trap.
    C. Supply shock.

LO.l: Contrast the use of inflation, interest rate, and exchange rate targeting by central banks.

35. Central banks targeting low inflation usually do not set the inflation target at 0%. The *most likely* reason is:
    A. some inflation is viewed as being good for an economy.
    B. targeting zero percent inflation runs a higher risk of a deflationary outcome.
    C. it is very difficult to eliminate all inflation from a modern economy.

36. The *most likely* benefit of adopting an exchange rate target is:
    A. freedom to pursue redistributive fiscal policy.
    B. freedom to set interest rates according to domestic conditions.
    C. to “import” the inflation experience of the economy whose currency is being targeted.

37. Which of the following is *least likely* a feature of an inflation-targeting framework?
    A. A commitment to transparency.
    B. A central bank which is closely aligned with the government.
    C. A clear medium-term inflation target.

LO.m: Determine whether a monetary policy is expansionary or contractionary.

38. In an effort to influence the economy, a central bank conducted open market activities by buying government bonds. This implies that the central bank is *most likely* attempting to:
    A. expand the economy by increasing bank reserves.
    B. contract the economy through a higher policy interest rate.
    C. expand the economy through a higher policy interest rate.

39. Which of the following actions on the part of the central bank is *most* consistent with a contractionary monetary policy?
    A. Decreasing reserve requirements.
    B. Buying securities in the open market.
    C. Selling securities in the open market.

40. Monetary policy is most likely to be contractionary for:

	GDP growth rate	**Inflation Target**	**Policy Rate**
A.	3%	2%	6%
B.	1%	4%	5%
C	2%	3%	4%

LO.n: Describe limitations of monetary policy.

41. Monetary policy is limited because central bankers:
    A. cannot control the inflation rate perfectly.
    B. are appointed by politicians and are therefore never truly independent.
    C. cannot control the amount of money that economic agents put in banks, nor the willingness of banks to make loans.

42. Which of the following statements about quantitate easing (QE) is *most* accurate? QE helps revive an ailing economy from:
    A. a liquidity trap.
    B. a deflationary trap.
    C. declining bank reserves and economic activity.

LO.o: Describe roles and objectives of fiscal policy.

43. Which of the following is *not* an objective of fiscal policy?
    A. Allocating resources among economic agents and sectors in the economy.
    B. Controlling level of money supply and interest rates.
    C. Influencing the level of economic activity and aggregate demand.

44. A government has a budget surplus when:
    A. tax revenues exceed government spending.
    B. government spending exceeds tax revenue.
    C. tax revenue is equal to government spending.

LO.p: Describe tools of fiscal policy, including their advantages and disadvantages.

45. If a government increases its spending on domestically produced goods and increases taxes by the same amount, the aggregate demand will *most likely*:
    A. increase.
    B. decrease.
    C. remain unchanged.

46. Which of the following is *not* a fiscal policy tool?
    A. A decrease in social transfer payment.
    B. An increase in value added taxes
    C. An increase in deposit requirements for the buying of houses.

47. Which of the following is difficult to change without giving considerable notice?
    A. Excise duty
    B. Value-added tax
    C. Employment taxes.

48. Pam explains to her colleagues that government borrowing may divert private sector investment from taking place. Which of the following is she *most likely* referring to?
    A. Crowding out effect.
    B. Expansionary fiscal policy.
    C. Ricardian equivalence.

49. Which of the following will *most likely* be levied a direct tax?
    A. Fuel.
    B. Inheritance.
    C. Gambling.

50. Which of the following is *least likely* to be a desirable attribute of a tax policy?
    A. Fairness.
    B. Revenue sufficiency.
    C. Transparency.

51. Which of the following is *least likely* to be an advantage of using fiscal policy tools?
    A. Capital spending is formulated and implemented with ease.
    B. Indirect taxes can generate revenue at little or no cost.
    C. Social policies can be adjusted instantly by increasing taxes.

52. Which of the following statements is *most likely* correct?
    Statement I: Discretionary fiscal policy requires timely decisions.
    Statement II: Non-discretionary fiscal policy refers to automatic stabilizers built into the system.
    Statement III: Discretionary policy deals with government spending while non-discretionary policy deals with taxes.
    A. Statements I and II.
    B. Statements I and III.
    C. Statements II and III.

LO.q: Describe the arguments about whether the size of a national debt relative to GDP matters.

53. A rise in government borrowing that reduces the ability of the private sector to access investment funds is *most likely* known as:
    A. Ricardian equivalence.
    B. crowding-out effect.
    C. Fisher effect.

54. The theory that private savings rise in anticipation of the need to repay principal on government debt is *most likely* known as:
    A. Ricardian equivalence.
    B. crowding-out effect.
    C. Fisher effect.

LO.r: Explain the implementation of fiscal policy and difficulties of implementation.

55. In an economy the marginal propensity to consume is 86% and the tax rate is 30%. If planned government expenditures are expected to increase by $2 billion, the increase in total incomes and spending ($ in billions) is *closest* to:
    A. $2.0.
    B. $2.5.
    C. $5.0.

56. During recession, the *most likely* steps implemented under fiscal policy would be to:
    A. decrease government spending or increase taxes.
    B. decrease government spending and decrease taxes.
    C. increase government spending or decrease taxes.

57. Given that the tax rate is 20% and the marginal propensity to spend is 85%, the fiscal multiplier is *closest* to:
    A. 1.20.
    B. 1.47.
    C. 3.13.

LO.s: Determine whether a fiscal policy is expansionary or contractionary.

58. An expansionary fiscal policy is *most likely* associated with:
    A. an increase in government spending on social benefits.
    B. crowding out of private investments.
    C. a decrease in capital gains tax rates.

59. A contractionary fiscal policy is *least likely* to include a decrease in:
    A. budget deficit.
    B. tax rates.
    C. government expenditures.

60. Which of the following statements is *most likely* correct?
    A. An expansionary fiscal policy followed by a tight monetary policy results in higher output and higher interest rates.
    B. A tight fiscal policy accompanied by an easy monetary policy causes the private sector to shrink.
    C. An easy fiscal policy and an easy monetary policy results in growing public sector, but shrinking private sector.

61. The Congo government decreased the reserve requirement. This is *most likely* to be an example of a/an:
    A. contractionary monetary policy.
    B. expansionary monetary policy.
    C. neutral monetary policy.

LO.t: Explain the interaction of monetary and fiscal policy.

62. What is the *most likely* economic outcome if expansionary fiscal policy is combined with contractionary monetary policy?
    A. Higher aggregate demand and higher interest rates, government spending increases.
    B. Lower aggregate demand, higher interest rates, and government spending decreases.
    C. Higher aggregate demand, lower interest rates, and government spending increases.

63. What is the *most likely* economic outcome if contractionary fiscal policy is combined with expansionary monetary policy?
    A. Higher interest rates and decreased government spending along with low private sector growth.
    B. Higher interest rates and increased government spending along with low private sector growth.
    C. Lower interest rates and decreased government spending along with high private sector growth.

64. What is the *most likely* economic outcome if contractionary fiscal policy is combined with contractionary monetary policy?
    A. Lower interest rates, higher GDP and contracted private sector.
    B. Higher interest rates, lower GDP and contracted private sector.
    C. Higher interest rates, lower GDP and expanded private sector.

65. The economy of Zimbabwe is slowing but policymakers take time to realize that. The data appears with considerable time lag and may be subject to revision. The lag described in this scenario is *most likely* a/an:
    A. Action lag.
    B. Impact lag.
    C. Recognition lag.

Solutions

1. A is correct. Monetary policy seeks to influence the macro economy by influencing the quantity of money and credit in the economy, while fiscal policy involves the use of government spending and taxation to influence economic activity.

2. C is correct. The primary goal of a fiscal policy is to use taxation and spending to influence the economic activity.

3. B is correct. To fulfill its role as a medium of exchange, money should have a high value relative to its weight.

4. C is correct. Money can buy goods and services – medium of exchange.
   Money does not perish physically – acts as a store of wealth.
   Money can define price of goods and services – unit of account.

5. B is correct. Narrow money generally means notes and coins in circulation in an economy, plus other very highly liquid deposits.

6. B is correct. Money should be difficult to counterfeit for it to act as a liberating medium of exchange.

7. C is correct. The increase in money from an additional deposit in the banking system = new deposit/reserve requirement. = \$100/0.08 = 1250.

8. C is correct.
   $$\text{Money created} = \frac{\text{Deposit}}{\text{Reserve Requirement}} = \frac{200}{0.1} = 2{,}000$$

9. C is correct. Speculative demand for money relates to the demand to hold speculative money balances based on the potential opportunities or risks that are inherent in other financial instruments.

10. A is correct. If the expected return on other assets falls, then the opportunity cost of holding money also falls and can, in turn, lead to an increase in the speculative demand for money.

11. A is correct. Decreasing the supply of money, all other things being equal, will increase its “price,” that is, the interest rate on money balances.

12. C is correct. As the gross domestic product (GDP) grows over time, both transactions and precautionary money balances increase.

13. A is correct. B is incorrect because the spending, P * Y, is approximately proportional to quantity of money, M. C is incorrect because if money neutrality holds, an increase in the money supply, M, does not affect Y, real output.

14. C is correct. The speculative demand for money relates to demand to hold speculative money balances based on the potential opportunities or risks that are inherent in other financial instruments.

15. B is correct. The Fisher effect states that the nominal interest rate is the sum of the real interest and the expected rate of inflation over a given time horizon. A decrease in expected inflation will result in a lower nominal rate.

16. B is correct. The three components of nominal interest rate are, compensation for expected inflation, real interest rate, and risk premium.

17. B is correct. Central banks normally have a variety of objectives, but the overriding one is nearly always price stability.

18. C is correct. All responsibilities given in the table are those of the central bank.

19. A is correct. The costs described are known as menu costs.

20. C is correct. Unexpected inflation reduces the information content of market prices.

21. A is correct. The costs associated with inflation are menu costs and shoe leather costs.

22. B is correct. Generally speaking, the higher the policy rate, the higher the potential penalty that banks will have to pay to the central bank. If they run short of liquidity, the greater will be their willingness to reduce lending, and the more likely that broad money growth will shrink.

23. A is correct. Increasing the reserve requirement will decrease the money supply, money multiplier and new deposits.

24. C is correct. In accordance to the monetary transmission mechanism, implementation of the policy is most likely to work through the economy via four channels i.e. bank lending rates, exchange rates, asset prices, and expectations or confidence.

25. C is correct. A change in a central bank's policy rate will affect both asset prices and expectations about future interest rates.

26. B is correct. The central bank's policy rate works through the economy via interconnected channels. An increase in the official interest rate will put a downward pressure on inflation.

27. B is correct. If a central bank operates within an inflation-targeting regime and if economic agents believe that it will achieve its target, this expectation will become embedded into wage negotiations, for example, and become a self-fulfilling prophecy.

28. C is correct. Central banks that are both operationally and target independent, not only decide the level of interest rates, but they also determine the definition of inflation that they target, the rate of inflation that they target, and the horizon over which the target is to be achieved.

29. A is correct. Banks tasked to hit a definition and level of inflation determined by the government are operationally independent. Target independent banks also determine the definition of inflation, the rate of inflation, and the horizon over which the target is achieved.

30. A is correct. An increase in the money supply leads to a decrease in nominal rates. Furthermore, on the basis of quantity theory of money, an increased money supply makes money less valuable, which increases aggregate price levels.

31. A is correct. If a decrease in the central bank's policy rate is successfully transmitted via the money markets to other parts of the financial sector, consumer demand might increase as the rate of interest on mortgages and other credit declines. This will put an upward pressure on consumer prices.

32. B is correct. An increase in the growth rate of money supply will cause the domestic currency to depreciate relative to those of the country's trading partners.

33. B is correct. Demand shocks cause a rise in inflation resulting from increased consumer confidence leading to more consumption as well as increased investment growth rates.

34. B is correct. A liquidity trap occurs when further injection of money into the economy does not affect real activity.

35. B is correct. When the bank targets inflation, the actual inflation may vary by some percentage. If it goes below zero percent, it results in negative inflation called deflation, which is not good for any economy.

36. C is correct. Note that interest rates have to be set to achieve this target and are therefore subordinate to the exchange rate target and partially dependent on economic conditions in the foreign economy.

37. B is correct. Inflation targeting requires an independent and credible central bank. A and C are features of an inflation-targeting framework.

38. A is correct. Buying government bonds results in an increase of the bank's reserves and increases banks' ability to lend, causing an increase in money growth through the multiplier mechanism and results in an expansion in the economy.

39. C is correct. When a central bank sells securities, bank reserves decrease. So the banks have to decrease their lending, thereby decreasing the money supply.

40. A is correct. Monetary policy is contractionary when the policy rate is above the neutral rate. Hence, when policy rate is 6% and neutral rate is 5% (3% + 2%), the policy is contractionary.

41. C is correct. Central bankers do not control the decisions of individuals and banks that can influence the money creation process.

42. C is correct. QE is an unconventional approach to monetary policy and is operationally similar to open market purchase operations, but conducted on a much larger scale. The idea is that additional reserves created by central banks would kick-start lending, which would eventually lead to an increase in real economic activity.

43. B is correct. Controlling level of money supply and interest rates is not an objective of fiscal policy.

44. A is correct. A government has a budget surplus when tax revenues exceed government spending.

45. A is correct. Aggregate spending will fall less than the tax rise by a factor of c (where c is the marginal propensity to consume). This additional output will, in turn, lead to further increases in income and output through the multiplier effect.

46. C is correct. Rises in deposit requirements for house purchases are intended to reduce the demand for credit for house purchases and hence would be considered a tool of monetary policy.

47. C is correct. Employment taxes apply to labor income and are direct taxes. Hence, they are difficult to change without giving considerable notice.

48. A is correct. Government borrowing may divert private sector investment from taking place. This effect is called the crowding out effect.

49. B is correct. Inheritance tax is a direct tax; fuel duties and taxes on gambling are indirect taxes.

50. C is correct. The four desirable attributes of a tax policy include fairness, revenue sufficiency, efficiency, and simplicity.

51. A is correct. Capital spending takes longer to formulate and implement, which makes it a disadvantage as a fiscal policy tool.

52. A is correct. Statement III is incorrect because government spending and taxes are tools of fiscal policies.

53. B is correct. A rise in government borrowing that reduces the ability of the private sector to access investment funds is known as crowding out effect.

54. A is correct. Ricardian equivalence states that private savings rise in anticipation of the need to repay principal on government debt.

55. C is correct. The fiscal multiplier is 1/ [1 – c*(1-T)] = 1/ [1 - 0.86 (1-0.3)] = 2.5.
    With government expenditure of $2 billion, total income and spending will rise by $2 billon * 2.5 = $ 5.0 billion.

56. C is correct. During a recession, the government will either increase government spending or decrease taxes.

57. C is correct.

$$\text{Fiscal Multiplier} = \frac{1}{[1 - c(1 - t)]} = \frac{1}{[1 - 0.85(1 - 0.2)]} = 3.13$$

58. B is correct. Expansionary policy increases government borrowing, which may divert private sector investment from taking place. This is known as the crowding out effect.

59. B is correct. A contractionary fiscal policy means that the government decreases its purchases of goods and services and/or raises taxes to decrease aggregate demand. A decrease in budget deficit would be associated with a contractionary fiscal policy.

60. A is correct. B is incorrect because a tight fiscal policy accompanied by an easy monetary policy causes the public sector to shrink. C is incorrect because an easy fiscal policy and an easy monetary policy results in growing public and private sector.

61. B is correct. A lower reserve requirement increases the money supply in the economy. This is an example of an expansionary monetary policy.

62. A is correct. Expansionary fiscal policy combined with contractionary monetary policy results in higher aggregate demand, higher interest rates and increased government spending as a part of GDP.

63. C is correct. Contractionary fiscal policy combined with expansionary monetary policy results in lower interest rates and decreased government spending along with high private sector growth.

64. B is correct. Contractionary fiscal policy combined with contractionary monetary policy results in higher interest rates and contracted private sector along with lower GDP.

65. C is correct. Recognition lag is the time lag due to late realization and data collection. Action lag is the time taken to implement policies. Impact lag is the time taken for actions to become evident.