CHAPTER 12

MONETARY AND FISCAL POLICY

1. (A) sell government securities in the open market.

Explanation

Selling government securities on the open market reduces bank reserves and drives up the federal funds rate. The other two statements are incorrect because the Federal Reserve does not directly control exchange rates or the prices of government securities.

For Further Reference:

(Study Session 4, Module 12.2, LOS 12.h)

CFA® Program Curriculum, Volume 2, page 291

Related Material

SchweserNotes - Book 1

J.K. SHAH® ONLINE

2. (C) $6.67 billion.

Explanation

The money multiplier is 1 / 0.15 = 6.67, so the open market purchase can increase the money supply by a maximum of $6.67 billion.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

3. (B) inflation rate is likely to increase.

Explanation

The central bank should increase target interest rates when the economy is growing at an unsustainable (above-full-employment) level. Decreasing the target overnight rate is likely to further increase aggregate demand and cause inflation to accelerate, which will be detrimental to the long-term growth rate of the economy.

(Study Session 4, Module 12.2, LOS 12.k)

Related Material

SchweserNotes - Book 1

4. (A) excess reserves.

Explanation

Excess reserves are the amount of money a commercial bank has available with which to make new loans, after depositing its required reserves with the central bank.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

5. (B) **Expansionary fiscal policy and contractionary monetary policy.**

Explanation

Expansionary fiscal policy tends to expand the public sector. Contractionary monetary policy tends to contract the private sector.

(Study Session 4, Module 12.3, LOS 12.t)

Related Material

SchweserNotes - Book 1

6. (A) **action lag.**

Explanation

The time it takes for fiscal policy actions to be proposed, approved, and implemented is referred to as action lag.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

7. (B) **the supply of money and credit.**

Explanation

Monetary policy attempts to influence economic growth and inflation by increasing or decreasing the money supply and the availability of credit in the economy. Taxes and government spending are tools of fiscal policy. Monetary and fiscal policy can both influence currency exchange rates, but this is not typically their primary goal or tool.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

8. (A) **a budget deficit during a recession and a budget surplus during an inflationary expansion.**

Explanation

Automatic stabilizers such as unemployment compensation, corporate profits tax, and the progressive income tax run a deficit during a business slowdown but run a surplus during an economic expansion. Therefore, they automatically implement countercyclical fiscal policy without the delays associated with policy changes that require legislative action.

(Study Session 4, Module 12.3, LOS 12.o)

Related Material

SchweserNotes - Book 1

9. (C) **Lending money to government agencies.**

Explanation

Lending money to government agencies is not typically a function of a central bank. Central bank functions include controlling the country's money supply to keep inflation within acceptable levels and promoting a sustainable rate of economic growth, as well as issuing currency and regulating banks.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book 1

10. (A) **GDP growth in the short run.**

Explanation

If the central bank has a price stability mandate, it will most likely respond to the above-target inflation rate by decreasing the money supply, even though GDP growth is in a recessionary phase. Decreasing the money supply will result in higher short-term interest rates and appreciation of the currency, but will likely cause GDP growth to decrease further in the short run.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book 1

11. (C) **GDP of a country divided by its money supply.**

Explanation

Velocity is the average number of times per year each dollar is used to buy goods and services (velocity = nominal GDP / money). Therefore, the money supply multiplied by velocity must equal nominal GDP. The equation of exchange must hold with velocity defined in this way. Letting money supply = M, velocity = V, price = P, and real output = Y, the equation of exchange may be symbolically expressed as: MV = PY.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

12. (A) **decrease the policy rate and make open market purchases of securities.**

Explanation

Decreasing the policy rate, decreasing reserve requirements, and purchasing securities in the open market are expansionary monetary policy actions.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

13. (B) **economic actors base decisions on the central bank's stated inflation targets.**

Explanation

If a central bank has credibility, economic actors come to believe the inflation rate will be near the central bank's target and factor this inflation rate into their decisions. Periodic inflation reports enhance the transparency of a central bank. A

central bank that determines both the policy rate and the method for computing the inflation rate is said to have independence.

For Further Reference:

(Study Session 4, Module 12.2, LOS 12.j)

CFA® Program Curriculum, Volume 2, page 295

Related Material

SchweserNotes - Book 1

14. (B) increased more than the growth in the money supply.

Explanation

The equation of exchange is MV = PY. If velocity (V) is increasing faster than real output (Y), inflation (P) would have to be increasing faster than the money supply (M) to keep the equation in balance.

For Further Reference:

(Study Session 1, Module 3.2, LOS 3.k)

CFA® Program Curriculum, Volume 2, page 272

CFA® Program Curriculum, Volume 2, page 291

Related Material

SchweserNotes - Book 1

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15. (C) 3%.

Explanation

Because they consider deflation to be disruptive to an economy, central banks typically choose inflation targets and bands that do not include a negative rate of inflation.

(Study Session 4, Module 12.2, LOS 12.1)

Related Material

SchweserNotes - Book 1

16. (B) increase in a fiscal surplus.

Explanation

An increase in a fiscal surplus or a decrease in a fiscal deficit is contractionary. An increase in a fiscal deficit or a decrease in a fiscal surplus is expansionary.

(Study Session 4, Module 12.3, LOS 12.$)

Related Material

SchweserNotes - Book 1

17. (B) Reciprocal of the required reserve ratio.

Explanation

The potential deposit expansion multiplier = 1 / (required reserve ratio)

The potential increase in the money supply = potential deposit expansion multiplier x increase in excess reserves

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

18. (C) **buy government securities.**

Explanation

Buying government securities is an expansionary policy that would increase the money supply and allow the inflation rate to increase to the targeted range. Increasing reserve requirements and overnight lending rates are contractionary and would have the opposite effects.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

19. (A) **Deflation.**

Explanation

Deflation is difficult for central banks to address when policy rates cannot be lowered any further. Inflation can be addressed by contractionary monetary policy. Stagflation is difficult to address because monetary policy cannot pursue higher growth and lower inflation at the same time.

(Study Session 4, Module 12.2, LOS 12.n)

Related Material

SchweserNotes - Book 1

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20. (A) **Improvements in quantitative methods have made the occurrence of recessions or expansions quite predictable.**

Explanation

One problem in achieving proper timing in fiscal policy is the inability to accurately predict a recession or expansion.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

21. (A) **contractionary.**

Explanation

Monetary policy is contractionary when the policy rate is greater than the neutral rate, which is the sum of the real trend rate of economic growth and the target rate of inflation. Here, the neutral rate is 3% + 2% = 5% and the policy rate of 6% is greater than the neutral rate. Monetary policy is expansionary when the policy rate is less than the neutral interest rate.

(Study Session 4, Module 12.2, LOS 12.m)

Related Material

SchweserNotes - Book 1

22. (B) **exert a stabilizing influence on an economy.**

Explanation

Proper timing of discretional policy is needed to reduce economic instability. If timed incorrectly, the fiscal policy change could increase rather than reduce economic instability.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

23. (C) **decrease transfer payments to households.**

Explanation

Decreasing spending or increasing taxes are contractionary fiscal policy actions. Increasing spending or decreasing taxes are expansionary.

(Study Session 4, Module 12.3, LOS 12.$)

Related Material

SchweserNotes - Book 1

24. (A) **between 2% and 3%.**

Explanation

Central banks typically define price stability as a stable inflation rate of about 2% to 3%. A target of zero is not typically used because it would risk deflation.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book 1

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25. (C) **Central banks can control short-term interest rates directly, but long-term interest rates are beyond their control.**

Explanation

Central banks can control short-term interest rates directly. However, the decisions of consumers and businesses are based on long-term interest rates, which are beyond the control of central banks. Increasing the money supply will decrease interest rates and decreasing the money supply will increase interest rates.

(Study Session 4, Module 12.2, LOS 12.n)

Related Material

SchweserNotes - Book 1

26. (A) **The money supply will decrease.**

Explanation

If banks choose to hold excess reserves, they will decrease their lending. Less bank lending will cause the money supply to decrease.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

27. (A) neutral.

Explanation

The neutral rate of interest is real trend rate of economic growth plus the inflation target. In this example, the neutral rate = 2.5% + 2.5% = 5.0%. Because the policy rate is the same as the neutral rate of interest, monetary policy is neither contractionary nor expansionary.

(Study Session 4, Module 12.2, LOS 12.m)

Related Material

SchweserNotes - Book 1

28. (C) Incorrect Incorrect

Explanation

If the Fed increases the money supply and real interest rates decline, U.S. investors will seek higher real rates of return abroad and the U.S. dollar will depreciate as the dollar will be exchanged for foreign currencies in order to buy the foreign investments. Likewise, the decrease in real interest rates will reduce the inflow of funds from abroad as foreign investors seek higher rates of return outside the U.S. With a dollar that has depreciated, U.S. exports should increase, as U.S. products will become cheaper for foreign buyers. As such, both statements are incorrect.

(Study Session 4, Module 12.2, LOS 12.k)

Related Material

SchweserNotes - Book 1

29. (A) Buy Treasury securities and decrease bank reserve requirements.

Explanation

If the economy is in a recession, the Fed is likely to attempt to decrease short-term interest rates. Thus, the Fed will buy Treasury securities and decrease bank reserve requirements.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

30. (B) fiscal policy.

Explanation

Fiscal policy refers to actions by a government to influence economic activity through changes in taxes and government spending.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

31. (A) the same as that of the target currency.

Explanation

Successful exchange rate targeting should result in the same inflation rate in the targeting country as in the country of the target currency.

(Study Session 4, Module 12.2, LOS 12.1)

Related Material

SchweserNotes - Book 1

32. (C) active decisions regarding spending and taxing to affect economic growth.

Explanation

Discretionary fiscal policy, in contrast to automatic stabilizers, refers to active decisions by the government to affect economic growth through changes in government spending and taxation. Buying or selling securities in the open market is an example of monetary policy.

(Study Session 4, Module 12.3, LOS 12.o)

Related Material

SchweserNotes - Book 1

33. (B) Exports increase.

Explanation

Expansionary monetary policy decreases interest rates. This should cause the domestic currency to depreciate, which should increase foreign demand for the country's exports.

(Study Session 4, Module 12.2, LOS 12.k)

Related Material

SchweserNotes - Book 1

34. (A) higher than anticipated.

Explanation

Inflation that is higher than anticipated will result in a transfer of wealth from lenders to borrowers.

(Study Session 4, Module 12.1, LOS 12.g)

Related Material

SchweserNotes - Book 1

35. (A) buy Treasury securities.

Explanation

Buying Treasury securities pumps money into the economy, lowering interest rates. Higher reserve requirements will restrict the money supply, causing rates to rise. The Federal Reserve has no direct control over the yield on existing Treasury securities.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

36. (B) Worsen.

Explanation

Contractionary monetary policy likely will cause higher domestic interest rates and attract foreign capital. As foreign capital flows in, the currency will appreciate relative to other currencies. The higher cost of its currency will result in higher cost exports that become less attractive to other countries. Xanadu's trade balance will most likely worsen.

(Study Session 4, Module 12.2, LOS 12.k)

Related Material

SchweserNotes - Book 1

37. (B) Ricardian equivalence.

Explanation

If Ricardian equivalence holds, private savings will increase in anticipation of the future taxes required by a fiscal deficit. The crowding-out effect of government borrowing on private investment and the reduction in long-term economic growth due to higher future taxes argue in favor of being concerned about the size of a fiscal deficit.

(Study Session 4, Module 12.3, LOS 12.q)

Related Material

SchweserNotes - Book 1

38. (A) neutral interest rate.

Explanation

The neutral interest rate is the sum of the trend rate of real economic growth and the target inflation rate. Monetary policy is expansionary if the policy rate is less than the neutral interest rate and contractionary if the policy rate is greater than the neutral interest rate.

(Study Session 4, Module 12.2, LOS 12.m)

Related Material

SchweserNotes - Book 1

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39. (B) both fiscal and monetary policy.

Explanation

Both monetary and fiscal policies are used by policymakers with the goals of maintaining stable prices and producing positive economic growth.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

40. (B) Ricardian equivalence.

Explanation

Ricardian equivalence suggests that it does not matter whether a government finances its spending with debt or a tax increase because the effect on the total level of demand in the economy is the same. Arguments for being concerned about the size of the fiscal deficit include the crowding-out effect of government borrowing taking the place of private sector borrowing and the negative effects on work incentives and entrepreneurship from higher future taxes.

(Study Session 4, Module 12.3, LOS 12.q)

Related Material

SchweserNotes - Book 1

41. (C) reduce the money supply.

Explanation

The quantity theory focuses on the quantity of money. The quantity theory states that velocity is not affected by monetary policy. Increasing banks' excess reserves would most likely lead to higher inflation.

For Further Reference:

(Study Session 4, Module 12.1, LOS 12.c)

CFA® Program Curriculum, Volume 2, page 272

Related Material

SchweserNotes - Book 1

42. (A) plus the expected inflation rate.

Explanation

The Fisher effect states that a nominal rate of interest equals a real rate plus expected inflation.

(Study Session 4, Module 12.1, LOS 12.e)

Related Material

SchweserNotes - Book 1

43. (C) As the Fed reduces the money supply, short-term interest rates decrease.

Explanation

As the Fed reduces the money supply, short-term interest rates increase. The other statements concerning the demand and supply for money are true.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

44. (C) concerns taxes and government spending, while monetary policy concerns the money supply.

Explanation

The distinction between fiscal and monetary policy is that a country's government determines fiscal policy through taxes and spending, but its central bank determines monetary policy by controlling the money supply. Both fiscal and monetary policy can be used to promote economic growth and price stability. Either fiscal policy or monetary policy can be expansionary or contractionary.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

45. (A) As the interest rate rises, the supply of money also rises.

Explanation

The supply of money is determined by the monetary authorities and is not affected by changes in interest rates. Thus, the supply of money curve is vertical.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

46. (A) Collect tax payments.

Explanation

The three functions of a central bank are to issue a country's currency, regulate its banking system, and to manage the money supply. Tax collection is typically conducted by a government agency created specifically to carry out that function.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book_1

47. (B) reduce government expenditures on major government construction projects.

Explanation

Discretionary fiscal policy refers to the federal government's decisions regarding government spending and taxing. A reduction in government spending on major government construction projects is likely to lead to a reduction in aggregate demand and less pressure on prices, reducing inflation.

(Study Session 4, Module 12.3, LOS 12.p)

Related Material

SchweserNotes - Book 1

48. (C) vertical.

Explanation

The money supply schedule is vertical because it is not affected by changes in the interest rate but is determined by the monetary authorities such as the Federal Reserve System (Fed) in the United States.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

49. (C) the monetary authorities.

Explanation

The monetary authorities determine the quantity of money available to the economy. Inflation and interest rates affect the demand for money balances.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

50. (A) an automatic fiscal policy stabilizer.

Explanation

Unemployment compensation automatically rises and falls with the business cycle, therefore it is an example of an automatic fiscal policy stabilizer.

(Study Session 4, Module 12.3, LOS 12.o)

Related Material

SchweserNotes - Book 1

51. (C) aid in increasing GDP and employment if the economy is operating at less than potential GDP.

Explanation

One potential argument against being concerned about the size of fiscal deficits is that a deficit can help increase GDP and employment if output is below potential GDP and the spending does not divert capital from productive uses. Higher deficits that lead to crowding out or higher future taxes that result in lower long-term economic growth are arguments for concern about the size of fiscal deficits.

(Study Session 4, Module 12.3, LOS 12.q)

Related Material

SchweserNotes - Book 1

52. (C) greater government deficits will drive up interest rates, thereby reducing private investment.

Explanation

The crowding-out effect refers to a reduction in private borrowing and investment as a result of higher interest rates generated by budget deficits that are financed by borrowing in the private loanable funds market.

For Further Reference:

(Study Session 4, Module 12.3, LOS 12.q)

CFA® Program Curriculum, Volume 2, page 316

Related Material

SchweserNotes - Book 1

53. (C) $40,000,000 increase.

Explanation

Buying securities by the Fed increases the money supply because they are injecting money into the banking system. The money supply can potentially increase by 1 / 0.25 x $10,000,000 = $40,000,000.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

54. (B) Both yields on short-term government debt and yields on long-term corporate debt.

Explanation

The Fisher effect holds that all nominal interest rates include a premium for expected inflation.

(Study Session 4, Module 12.1, LOS 12.e)

Related Material

SchweserNotes - Book 1

55. (C) both expected and unexpected inflation.

Explanation

Inflation imposes "menu costs" on an economy as businesses must frequently change their advertised prices, regardless of whether inflation is expected or unexpected.

(Study Session 4, Module 12.1, LOS 12.g)

Related Material

SchweserNotes - Book 1

56. (A) the interest rate is higher than its equilibrium rate.

Explanation

If real money balances are larger than households and firms desire, the interest rate (opportunity cost of holding money balances) is higher than its equilibrium rate. Households and firms will use their undesired cash to buy securities, bidding up securities prices and reducing the interest rate until the equilibrium rate is achieved. This market process does not require any action by the central bank.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

57. (B) target independence.

Explanation

Target independence means the central bank defines how inflation is computed, sets the target inflation level, and determines the horizon over which the target is to be achieved. Central banks that have operational independence are allowed to determine the policy rate. Transparency refers to the degree to which central banks report to the public on the state of the economic environment and is one of the three essential qualities of an effective central bank.

(Study Session 4, Module 12.2, LOS 12.j)

Related Material

SchweserNotes - Book 1

58. (B) both fiscal policy and monetary policy.

Explanation

Both fiscal and monetary policies are used to maintain stable prices and produce economic growth. Fiscal policy does so by mechanisms that involve spending and taxation, and monetary policy uses central bank tools to modify the availability of money and credit.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

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59. (C) **the foreign exchange value of the currency.**

Explanation

Contractionary monetary policy is likely to increase the value of the domestic currency in the foreign exchange market, which decreases foreign demand for the country's exports. Contractionary monetary policy should cause both securities prices and expectations for economic growth to decrease, each of which is likely to cause consumers to decrease spending.

(Study Session 4, Module 12.2, LOS 12.i)

Related Material

SchweserNotes - Book 1

60. (C) **Increase Increase**

Explanation

The amount of the spending program exactly offsets the amount of the tax increase, leaving the budget unaffected (balanced budget). The multiplier effect is stronger for government spending versus the tax increase. Therefore, the balanced budget multiplier will be positive. All of the government spending enters the economy as increased expenditure, whereas only a portion of the tax increase results in lessened expenditure (determined by the marginal propensity to consume), because part of the tax increase will come from the savings of the taxpayer (determined by the marginal propensity to save).

(Study Session 4, Module 12.3, LOS 12.p)

Related Material

SchweserNotes - Book 1

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61. (C) **Transaction costs.**

Explanation

Money functions as a medium of exchange because it is accepted as payment for goods and services. Compare this to a barter economy, where if I have goat and want an ox, I have to find someone willing to trade. Finding someone takes time and time is costly. With money, I can sell the goat and buy the ox. Thus, transaction costs are reduced. Having money as a medium of exchange would not reduce the inflation rate, interest rates, or the need to specialize in the production of those goods in which we have a comparative advantage (low opportunity cost producer).

(Study Session 4, Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 1

62. (C) **Sell Treasury securities, causing aggregate demand to decrease.**

Explanation

If the Federal Reserve wants to slow inflation, it needs to decrease aggregate demand (i.e., business investment, consumer purchases of durable goods, and exports). To accomplish this, the Federal Reserve could engage in open market sales of Treasury securities.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

63. (A) **a liquidity trap.**

Explanation

Deflation is often associated with liquidity trap conditions. A liquidity trap is a situation in which demand for money becomes highly elastic. Expanding the money supply has little effect on economic activity under these conditions because individuals and firms choose to hold the additional money in cash. "Bond market vigilantes" is an expression referring to the fact that expansionary monetary policy may cause long-term interest rates to increase, instead of decreasing as intended, if bond market participants expect the expansionary policy to increase future inflation rates.

(Study Session 4, Module 12.2, LOS 12.n)

Related Material

SchweserNotes - Book 1

64. (B) **A decrease in the discount rate.**

Explanation

A decrease in the Fed's lending rate is a monetary tool that the Fed can use to increase the money supply, thereby increasing aggregate demand during recessionary times when there is high unemployment. An increase in the reserve requirements and the sale of bonds by the Fed would all be restrictive monetary policies that would reduce the amount of money in the economy and reduce aggregate demand.

(Study Session 4, Module 12.3, LOS 12.t)

Related Material

SchweserNotes - Book 1

65. (B) **holding money when interest rates are higher will try to reduce their money balances and, as a result, the demand for money decreases.**

Explanation

Buying bonds would drive bond prices up and interest rates down. Selling bonds would have the opposite effect; driving bond prices down and interest rates up. When interest rates are lower, there is an excess demand for money. The supply of money is determined by the monetary authorities.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

66. (C) **sell government securities.**

Explanation

Open market operations to sell securities will decrease the outstanding supply of cash balances and increase short-term interest rates. The central bank does not issue long-term bonds but may buy and sell bonds issued by the government. Decreasing reserve requirements or purchasing government securities would tend to decrease short-term interest rates.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

67. (C) **enlarge the budget deficit (or reduce the surplus).**

Explanation

During a recession unemployment is high, so the government will pay out more in unemployment compensation at the exact time that tax receipts from corporations and individuals are low. This will increase the size of the deficit and also maintain aggregate demand during recessionary periods.

(Study Session 4, Module 12.3, LOS 12.o)

Related Material

SchweserNotes - Book 1

J.K. SHAH® ONLINE

68. (B) **fiscal policy only.**

Explanation

Fiscal policy can be used as a tool for redistribution of income and wealth, through a variety of taxation and spending policies.

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

69. (C) **the policy rate.**

Explanation

A central bank is said to have operational independence if it has the authority to determine the policy rate independently. Determining how inflation is calculated and the time horizon for achieving its target rate of inflation refer to a central bank that has target independence.

(Study Session 4, Module 12.2, LOS 12.j)

Related Material

SchweserNotes - Book 1

70. (A) **Independence, credibility, and transparency.**

Explanation

A central bank that is independent from political interference, possesses credibility, and exhibits transparency is more likely to achieve its monetary policy objectives than a central bank that lacks these qualities. The other characteristics listed in the answer choices relate to financial statements and financial reporting standards.

(Study Session 4, Module 12.2, LOS 12.j)

Related Material

SchweserNotes - Book 1

71. (C) **$500 million.**

Explanation

Potential expansion multiplier = $\frac{1}{\text{required reserve ratio}} = \frac{1}{0.2} = 5$

(100)(5) = 500

For Further Reference:

(Study Session 4, Module 12.1, LOS 12.c)

CFA® Program Curriculum, Volume 2, page 272

Related Material

SchweserNotes - Book 1

72. (C) **$10,000,000.**

Explanation

The maximum increase in the money supply from a fractional reserve banking system is the money multiplier (1 / reserve requirement) times the amount of a new deposit of cash. 1/0.10 x $1 million = $10 million.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

73. (B) **Both are expansionary.**

Explanation

Expansionary fiscal policy increases a budget deficit or decreases a budget surplus. Contractionary fiscal policy decreases a budget deficit or increases a budget surplus.

(Study Session 4, Module 12.3, LOS 12.$)

Related Material

SchweserNotes - Book 1

74. (A) discount rate.

Explanation

Banks are able to borrow from the Fed at the discount rate. The federal funds rate is the interest rate banks charge other banks to borrow reserves from other banks. The prime rate is the rate that commercial banks charge their best customers.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book 1

75. (B) money received for work or goods can be saved to purchase goods or services in the future.

Explanation

Money has three primary functions: it provides a store of value because money received for work or goods can be saved for future consumption; it serves as a unit of account because prices of all goods and services are expressed in units of money; and it serves as a medium of exchange because money is accepted as a form a payment.

(Study Session 4, Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 1

76. (B) decreased, which reduces the amount of money banks are able to lend, causing an increase in the federal funds rate.

Explanation

When the Federal Reserve wants to increase the federal funds rate through open market operations, it sells government securities. Open-market sales reduce bank reserves and cause the federal funds rate to increase.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

77. (C) short-term interest rates.

Explanation

The demand for money curve represents the relationship between short-term interest rates and the quantity of real money that households and firms demand to hold.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

78. (B) increases in transfer payments and decreases in tax revenues that result from an economic contraction without new legislation.

Explanation

Automatic stabilizers refers the increase (decrease) in transfer payments such as unemployment compensation and the decrease (increase) in tax revenue that result from a decrease (increase) in the level of economic activity. These effects tend to move the fiscal budget toward a deficit when economic activity decreases and

toward surplus when economic activity increases, and tend to dampen economic cycles.

(Study Session 4, Module 12.3, LOS 12.o)

Related Material

SchweserNotes - Book 1

79. (A) control inflation.

Explanation

Although some central banks have other stated goals including stabilizing exchange rates and achieving full employment, the primary objective for a central bank is to control inflation and promote price stability.

(Study Session 4, Module 12.1, LOS 12.f)

Related Material

SchweserNotes - Book 1

80. (A) Correct Incorrect

Explanation

Necco is correct because the multiplier effect is stronger for government expenditures versus government taxes. All of the increase in government spending enters the economy as increased expenditure, whereas only a portion of the tax increase results in lessened expenditure (determined by the marginal propensity to consume), because part of the tax increase will come from the savings of the taxpayer (determined by the marginal propensity to save). Packard is incorrect; the effect on real GDP of an increase in government spending combined with equal increase in taxes will be positive because the multiplier effect is stronger for government spending versus the tax increase.

(Study Session 4, Module 12.3, LOS 12.p)

Related Material

SchweserNotes - Book 1

81. (C) prices of goods and services are expressed in units of money.

Explanation

Money has three primary functions: it serves as a unit of account because prices of goods and services are expressed in units of money; it provides a store of value because money received for work or goods can saved to purchase goods or services at another time; and it serves as a medium of exchange because money is accepted as a form a payment.

(Study Session 4, Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 1

82. (B) demand for money in the money market, and investors will tend to be net sellers of securities.

Explanation

At interest rates below 4% (the long-term equilibrium rate), the quantity of money demanded exceeds the quantity of money supplied. At below-equilibrium rates, investors will sell bonds to obtain the desired extra cash. As they sell more bonds, the prices of bonds fall, and interest rates start to move back towards the 4% equilibrium.

For Further Reference:

(Study Session 4, Module 12.1, LOS 12.d)

CFA® Program Curriculum, Volume 2, page 278

Related Material

SchweserNotes - Book 1

83. (C) transaction demand, precautionary demand, and speculative demand.

Explanation

The three reasons for holding money are: transaction demand, for buying goods and services; precautionary demand, to meet unforeseen future needs; and speculative demand, to take advantage of investment opportunities. Narrow money and broad money refer to measures of money in circulation.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

J.K. SHAH® ONLINE

84. (C) a high proportion of government debt owed to the country's citizens.

Explanation

That a government owes its own citizens much of its outstanding debt is an argument against being concerned about fiscal deficits. Arguments for being concerned about fiscal deficits include the need for higher future taxes and the potential for government borrowing to increase interest rates and crowd out private investment.

For Further Reference:

(Study Session 4, Module 12.3, LOS 12.q)

CFA® Program Curriculum, Volume 2, page 316

Related Material

SchweserNotes - Book 1

85. (C) nominal and real interest rates.

Explanation

The Fisher effect states that a nominal interest rate is equal to a real interest rate plus the expected rate of inflation.

(Study Session 4, Module 12.1, LOS 12.e)

Related Material

SchweserNotes - Book 1

86. (B) less severe.

Explanation

Costs of inflation are less severe when inflation is correctly anticipated than when inflation is unexpected. Unexpected inflation results in wealth being transferred from lenders to borrowers. In addition, producers might misallocate resources if they cannot determine whether an increase in the price of their output reflects inflation or a genuine increase in demand.

(Study Session 4, Module 12.1, LOS 12.g)

Related Material

SchweserNotes - Book 1

87. (B) impact lag in discretionary fiscal policy.

Explanation

This is an example of discretionary fiscal policy involving impact lag because it takes time for the impact of the change in taxing and spending to be felt throughout the economy.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

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88. (A) increased exports of U.S. goods.

Explanation

When the Fed sells Treasuries, it causes both short- and long-term interest rates to increase. This rate increase causes the dollar to appreciate, which reduces foreign demand for domestic goods, causing exports to decline. The interest rate increase also puts downward pressure on price levels, which causes inflation to slow.

(Study Session 4, Module 12.2, LOS 12.i)

Related Material

SchweserNotes - Book 1

89. (B) the demand for money only.

Explanation

Interest rates only affect the demand for money. With higher interest rates, the opportunity cost of holding money increases, and people hold less money and more interest-earning assets. Monetary authorities determine the supply of money. Therefore, the supply of money is independent of the interest rate.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

90. (B) Requiring the banking system to tighten or loosen its credit policies.

Explanation

The U.S. Federal Reserve can encourage or persuade banks as a whole to tighten or loosen their credit policies, but it cannot compel them to do so.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

91. (A) budget deficit will increase the real interest rate and thereby retard private investment.

Explanation

Increased budget deficits will increase the demand for loanable funds and lead to higher interest rates and thus lower private investment. Crowding-out implies that an increase in government spending will choke off private investment and reduce the intended impact of fiscal policy changes on aggregate demand.

(Study Session 4, Module 12.3, LOS 12.q)

Related Material

SchweserNotes - Book 1

92. (C) impact lag.

Explanation

The time it takes for a fiscal policy action, once implemented, to have its effect on the economy is referred to as impact lag. Recognition lag is the time it takes policymakers to realize a fiscal policy response is needed. Action lag is the time it takes policymakers to discuss, enact, and implement fiscal policy measures.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

93. (A) If the Fed wants to stimulate the economy, it will sell Treasury securities to banks.

Explanation

If the Fed intends to stimulate the economy, they will buy, not sell, Treasury securities. Buying Treasury securities injects reserves into the banking system.

(Study Session 4, Module 12.2, LOS 12.h)

Related Material

SchweserNotes - Book 1

94. (C) Nominal GDP = Price x Money Supply.

Explanation

The quantity theory of money holds that: Money Supply x Velocity = Nominal GDP = Price x Real Output.

(Study Session 4, Module 12.1, LOS 12.c)

Related Material

SchweserNotes - Book 1

95. (A) The private sector as a percentage of GDP will increase.

Explanation

The private sector will expand as a percentage of GDP because (1) the public sector will decrease as a percentage of GDP due to government spending cuts and (2) lower interest rates should cause the private sector to expand.

(Study Session 4, Module 12.3, LOS 12.t)

Related Material

SchweserNotes - Book 1

96. (A) An increase in the real rate of interest.

Explanation

If the U.S. Federal Reserve decreases the money supply, an increase in nominal and real interest rates will occur. Higher real rates will cause businesses to invest less, which will cause the unemployment rate to increase. Furthermore, households will decrease purchases of durable goods, automobiles, and other items that are typically financed at short-term rates. This will decrease aggregate demand. The decrease in aggregate demand and expenditures will cause incomes to go down, which further decreases consumption and investment. Moreover, this decrease in aggregate demand will decrease real GDP and the price level in the short run and the long run.

(Study Session 4, Module 12.2, LOS 12.i)

Related Material

SchweserNotes - Book 1

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97. (C) Interest rate.

Explanation

Interest rates are determined by the equilibrium between money supply and money demand.

(Study Session 4, Module 12.1, LOS 12.d)

Related Material

SchweserNotes - Book 1

98. (B) recognition lag.

Explanation

Recognition lag refers to the time it takes for fiscal policy makers to determine the need for a policy action. Action lag is the time it takes policymakers to discuss, enact, and implement fiscal policy measures. Impact lag is the time it takes for a fiscal policy measure to have its effect on the economy.

(Study Session 4, Module 12.3, LOS 12.r)

Related Material

SchweserNotes - Book 1

99. (A) contractionary.

Explanation

When the central bank increases short-term interest rates, it is attempting to decrease the growth rate of money and credit in an economy, and policy is said to be contractionary, restrictive, or tight. Accommodative or expansionary monetary policy attempts to increase the growth rate of money and credit (e.g., by decreasing short-term interest rates).

(Study Session 4, Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 1

100. (A) Inflation targeting.

Explanation

Inflation targeting is the most-used tool of central banks for making monetary policy decisions.

(Study Session 4, Module 12.2, LOS 12.1)

Related Material

SchweserNotes - Book 1