

Multiple-choice questions to accompany

MACROECONOMIC ESSENTIALS FOR MEDIA INTERPRETATION

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This set of multiple-choice questions has been prepared for instructors wishing a bank of such questions for examination purposes, and for students who find studying from such questions to be an efficient way of learning. (My students have told me that the single best thing to do to ensure doing well in my course is to keep up to date with this bank of multiple-choice questions!) There are three generic types of questions.

Most numerous are questions based on short news clips, reflecting the unique flavor of Macroeconomic Essentials for Media Interpretation. It is because this text's focus on the interpretation of news commentary is so different from traditional texts that it was felt necessary to provide this set of multiple-choice questions. These questions are based almost exclusively on clips found in the text as examples or as end-of-chapter questions, and so students who have worked through the text should be familiar with them.

Second are questions providing numerical examples to be worked out. These questions are unlike traditional economics numerical multiple-choice questions, and so also reflect a unique character of the text. Again, almost all of these questions are similar to numerical questions found as end-of-chapter exercises in the text and so students who have worked through the text should be familiar with them.

Third are a few traditional multiple-choice questions, included for completeness.

As with all multiple-choice questions, the intent is that the best of the possible answers should be chosen. Answers are found at the end of each chapter's questions.

Although I have tried hard to remove ambiguities and errors, some such may remain, for which I apologize and accept full responsibility. Suggested corrections, sent to kennedy@sfu.ca, would be appreciated.

Chapter 3: Measuring GDP and the Price Level

1. "Almost all of the fourth quarter increase in GDP wound up as unsold inventory sitting on shelves." If it doesn't get sold, how could it get counted into GDP?
 - a) it is added when measuring GDP, as an element of investment demand
 - b) it is added when measuring GDP, as an element of consumption demand
 - c) it is subtracted when measuring GDP, as an element of investment demand

- d) it is subtracted when measuring GDP, as an element of consumption demand
2. "The oil crisis caused U.S. oil companies' overseas profits to shoot up, producing a jump in _____ that could mislead policy-makers." The blank should be
a) GDP b) GNP c) investment d) interest rates
3. "Suppose a new computer is invented that costs one-quarter of existing computers and performs as well. Now when GDP is calculated production of the same number of computers creates only one-quarter as much dollar output - GDP falls!"
a) true, both nominal and real GDP fall
b) false, real GDP should rise because of adjustments for quality
c) false, real GDP should rise because of price index adjustments
d) false, real GDP should be unchanged because of price index adjustments
4. "Homemakers often feel their work is taken for granted, and advocates in the women's movement argue that the statistical invisibility of homemakers' work has substantive policy implications." What is meant by "statistical invisibility" here?
a) homemakers' output is not counted in GDP
b) homemakers' output is double-counted in GDP
c) homemakers' output is added into GDP at an artificially-low price
d) homemakers' output is only counted into GDP if there exists a market counterpart
5. "Experts keen on the concept of Green GDP have offered a variety of suggestions to make economic statistics more environmentally friendly."
An example of such a suggestion is
a) add the cost of cleaning up after an oil spill
b) ignore the cost of cleaning up after an oil spill
c) subtract the cost of cleaning up after an oil spill
d) add output produced in private vegetable gardens
6. "He claimed that a better measure of Turkish national income could be obtained by including money sent back to their families by Turks living and working in Germany, something that is currently ignored in the national accounts." This income is
a) included in Turkish GDP b) included in Turkish GNP
c) included in both Turkish GDP and GNP
d) completely ignored in the Turkish accounts
7. "Note that the percent change in the GDP deflator is being used as the measure of inflation rather than the more familiar CPI. The GDP deflator is a price index that samples _____, not just those paid by consumers." The blank should be
a) all prices, including imports
b) prices of all domestically-produced goods and services
c) prices of all domestically-produced goods and services except exports
d) prices of all domestically-produced goods and services except those produced by government

8. "The government insists that the CPI measures consumer prices, not the cost of living. But don't shoot the CPI - whether bringing good news or bad, it's the best messenger we've got." During a typical inflation

- a) the CPI rises by less than the cost of living
- b) the CPI rises by more than the cost of living
- c) the CPI and the cost of living rise by the same amount
- d) there is no consistent relationship between rises in the CPI and in the cost of living

9. "The rapid development of computers makes it difficult to determine how much of the change in measured prices of computers is due to pure price change or due to the change in quality of the product. It is clear that the cost of obtaining a given amount of computing capability has been falling." If the national accounts statistician makes proper adjustments, this implies that computers should be causing the CPI to

- a) fall
- b) rise
- c) be steady
- d) move in no predictable direction

10. "As best we can tell, responded the central bank governor, the center of the 2 percent inflation target, namely 1 percent, appears to correspond to genuine price stability once the various sources of bias in the CPI are allowed for." An example of bias in the CPI measure is that it

- a) ignores import prices
- b) ignores investment goods
- c) ignores most quality changes
- d) values government output at cost

"The Commerce department announced that it is shifting from 1987 to 1992 as the base year for calculating the nation's real GDP and price index."

11. In the new official figures, compared to the old official figures, the 1987 number for real GDP is

- a) smaller
- b) unchanged
- c) larger
- d) not enough information to tell

12. In the new official figures, compared to the old official figures, the 1987 number for nominal GDP is

- a) smaller
- b) unchanged
- c) larger
- d) not enough information to tell

13. In the new official figures, compared to the old official figures, the 1987 number for the price index is

- a) smaller
- b) unchanged
- c) larger
- d) not enough information to tell

14. "The Commerce Department revised its estimate of real GDP to \$3.877 trillion, up from the earlier estimate of \$3.835 trillion. Before adjusting for inflation, GDP was \$4.603 trillion, up from \$4.523 trillion." The GDP deflator used for revised calculations is

- a) 118.0 or less
- b) more than 118.0 but not more than 118.5
- c) more than 118.5 but not more than 119.0
- d) more than 119.0

15. Suppose that inventories fall by \$2b, consumption increases by \$8b, unemployment insurance payments decline by \$4b and imports rise by \$1b. Then measured GDP should rise by

- a) \$5b
- b) \$7b
- c) \$9b
- d) \$11b

16. From the data below, the official measure of GDP is

- a) below 100 b) between 100 and 103 c) between 104 and 107 d) above 107

Personal Consumption Expenditures	62.0
Depreciation	5.0
Indirect Business Taxes less Subsidies	1.0
Gross Private Domestic Investment	15.0
Exports	12.0
Government Purchases of Goods and Services	20.0
Government Transfer Payments	4.0
Imports	11.0

17. Suppose the sum of consumption, investment, and government spending is \$620 billion, where investment includes involuntary inventory accumulation of \$2 billion in addition to expenditure on plant and equipment, and government spending includes \$5 billion interest payments on the national debt, \$5 billion unemployment insurance payments, \$10 billion social security payments, \$2 billion in salaries to elected politicians, \$14 billion in salaries to government employees and \$25 billion expenditure on goods and services produced by the private sector. If we imported \$3 billion more than we exported, measured GDP by the adding expenditures method is

- a) \$600b or less b) more than \$600b but not more than \$610b
c) more than \$610b but not more than \$620b d) more than \$620b

18. If in 1992 nominal GDP is 600 and real GDP is 500, then the price index for 1992

- a) is 100 b) is 120
c) cannot be calculated because we don't know the base year
d) cannot be calculated because we don't know last year's figures

19. If a typical market basket of goods and services cost \$120 in 1975, the base year, and \$180 in 1985, the price index in 1985 would be

- a) 120 b) 150 c) 160 d) 180

20. If the price index is 120 in 1989 and 150 in 1990, what is the rate of inflation?

- a) 20% b) 25% c) 30% d) more than 30%

21. Suppose nominal GDP is \$566 billion in 1986, \$600 billion in 1987 and \$642 billion in 1988. If 1986 is the base year, the price index is 105 in 1987, and real growth in 1988 is 3%, from this information, the price index in 1988 is

- a) less than 109 b) 109 c) greater than 109 but less than 110 d) 110 or over

22. Suppose hamburgers cost \$1.20 last year and \$1.32 this year, and the overall price index (the GDP deflator) rose from 110 last year to 120 this year.

How much will 1000 hamburgers contribute to this year's real GDP?

- a) \$1,000 b) \$1,100 c) \$1,200 d) \$1,320

23. If in 1994 nominal GDP is 540 and real GDP is 500, the price index for 1994 is

- a) 100 b) 108 c) 140 d) not enough information to tell

24. Suppose the price index is 110 and a typical basket of goods and services costs \$3,300. What would this typical basket have cost in the base year?

- a) \$30 b) \$3,000 c) \$3,630 d) not enough information to tell

25. If the CPI changes from 110 in 1993 to 120 in 1994, what is the rate of inflation?

- a) less than 10% b) 10% c) more than 10% d) insufficient information to tell

26. The CPI (base year 1987) for 1990 is 120, for 1991 is 125 and for 1992 is 130. If the base year is changed from 1987 to 1992, what does the CPI for 1990 become?

- a) 90 b) 92.3 c) 108.3 d) 110

27. If GDP increases in nominal terms from \$600 billion in 1994 to \$780 billion in 1996 and the price index (1992=100) rises from 120 to 130, how much real growth (in 1992 dollars) in GDP occurred between 1994 and 1996?

- a) \$100b b) \$138.5b c) \$150b d) \$180b

Suppose that in 1995 the price index (base year 1992) was 110 and income was \$700 billion. The corresponding numbers for 1996 are 120 and \$800 billion.

28. 1996 income expressed in 1992 dollars is

- a) less than \$600b b) \$600b or more but not more than \$700b
c) more than \$700b but not more than \$800b d) more than \$800b

29. 1996 income expressed in 1995 dollars is

- a) less than \$600b b) \$600b or more but not more than \$700b
c) more than \$700b but not more than \$800b d) more than \$800b

30. Inflation during 1996 was

- a) less than 10% b) 10%
c) more than 10% but not more than 20% d) more than 20%

31. A reduction in inventory is

- a) not considered in the national income accounts
b) entered as positive investment in the national accounts
c) entered as negative investment in the national accounts
d) entered as a depreciation item in the national accounts

32. Which of the following is counted as investment in national income accounting?

- a) building a new factory b) buying an existing house
c) purchasing corporate stocks and bonds d) depositing money in a commercial bank

33. Goods and services are valued at market prices when calculating GDP. Because the "outputs" of government are not sold, they have no market prices. In the actual calculation of GDP

- a) they are valued at zero b) they are valued at the cost of producing them
c) their value is estimated from a survey of recipients of these services
d) their value is estimated from the market prices of similar market-provided services

34. That GDP tends to overstate a nation's economic well-being is illustrated by its treatment of which of the following
- a) you buy a new generator for your barn
 - b) you decide to stay home to care for your children
 - c) you decide to work fewer hours to enjoy life more
 - d) the government spends millions cleaning up after an oil spill
35. Which of the following will be added to GDP as conventionally calculated?
- a) the cost of cleaning up an oil spill b) an unemployment insurance payment
 - c) dividends earned by an American on shares in a British company
 - d) the value of work done by a parent staying home to care for children
36. Which of the following raises measured GDP
- a) you are hired by GM to shuffle paper uselessly for \$200
 - b) a steel company sells some steel to an automobile manufacturer
 - c) you are hired by the government to shuffle paper uselessly for \$200
 - d) both a) and c) above
37. "But economists believe that one of the most important sources of bias in the CPI as a measure of the cost of living is when consumers shift their buying patterns in response to changing relative prices, buying ..." This clipping is best completed by
- a) more of everything b) less of everything
 - c) more of relatively cheaper things and less of relatively more expensive things
 - d) less of relatively cheaper things and more of relatively more expensive things.
38. "Republicans are already eyeing changes to the inflation measure as a way to meet their goal of halving the budget deficit by 2002. The CPI is used to adjust social security and other benefits, and income-tax brackets, for inflation." The suggested changes will lower the deficit because measured inflation will be
- a) increased which lowers real taxes b) decreased which increases real taxes
 - c) increased which increases social security payments
 - d) decreased which decreases social security payments
39. "A series of methodological improvements to the Consumer Price Index that will continue into 1999 is expected to add about half a percentage point to measured productivity growth, raising the economy's sustainable rate of GDP growth from between 2 percent and 2.25 percent to between 2.5 percent and 2.75 percent." This will increase measured productivity growth because
- a) of the inverse relationship between inflation and unemployment
 - b) lower inflation reduces uncertainty and increases investment, which promotes growth
 - c) if inflation comprises less of nominal GDP increases, real output increases must comprise more
 - d) this clipping is incorrect - changing the way something is measured should have no impact on growth

40. "High demand in this year's economy caught producers unaware, forcing their inventories to absorb this demand." How does this inventory change appear in the GDP calculation when adding up all expenditures?

- a) it is added when measuring GDP, as an element of investment demand
- b) it is added when measuring GDP, as an element of consumption demand
- c) it is subtracted when measuring GDP, as an element of investment demand
- d) it is subtracted when measuring GDP, as an element of consumption demand

41. If the typical market basket of goods and services cost \$400 in 1995, and the price index (base year 1992) for 1995 is 120, then if this same typical bundle cost \$420 in 1996, the price index in 1996 would be

- a) 120 or below
- b) between 120 and 125
- c) 125
- d) above 125

42. "The economists who set up GDP also established a number of rather arbitrary conventions to distinguish between investment and consumption components of GDP. Generally, goods and services purchased by households are treated as consumption expenditures, but _____ purchases are a major exception to this rule and are included in the investment category of GDP." The blank is best filled with new

- a) automobile
- b) housing
- c) clothing
- d) government bond

43. "Because pollution is a byproduct of many production processes, GDP accountants should adjust GDP _____ but do not, causing GDP to _____ economic welfare. The blanks are best filled with

- a) upwards; overstate
- b) upwards; understate
- c) downwards; overstate
- d) downwards; understate

Answers: 1a 2b 3d 4a 5b 6b 7b 8b 9a 10c 11c 12b 13a 14c 15a 16a 17a 18b 19b 20b 21c 22b 23b 24b 25a 26b 27a 28b 29c 30a 31c 32a 33b 34d 35a 36c 37c 38d 39c 40c 41d 42b 43c

Chapter 4: Unemployment

1. "Employment is projected to revive at 3.5 percent per year. Since the trend rate of increase in the labor force is just less than 2 percent per year, that would seem to produce a healthy decline in the unemployment rate of 1.5 percentage points per year. Unfortunately, that probably won't happen." It may not happen because of

- a) part-time workers
- b) discouraged workers
- c) encouraged workers
- d) a fall in the participation rate

2. "That is why the jump in May's unemployment rate - from 7.2 percent to 7.5 percent, the highest during this business cycle - caused dismay. Yet this may be missing the point. The number of people in the labor force in the month of May jumped by 330,000." The higher unemployment rate was probably caused by

- a) a fall in employment
- b) a massive destruction of jobs

- c) an increase in the participation rate
- d) an increase in the number of discouraged workers

3. "In any economic slowdown, the unemployment rate rises, first and foremost, because employment growth slows or actually goes into negative territory. But how high the jobless rate goes can also depend very crucially on exactly how fast the labor force decides to grow." Which of the following causes the labor force to grow more slowly.

- a) a rise in the participation rate
- b) an increase in encouraged workers
- c) an increase in discouraged workers
- d) homemakers looking for market jobs

4. "This council, an advisory body with business and union representation, decided to rethink the concept of unemployment. It was intent on unraveling the paradox of substantial new job creation coupled with a high and largely unyielding jobless rate."

This paradox could come about through

- a) a fall in the labor force
- b) a fall in the minimum wage
- c) an increase in the participation rate
- d) an increase in the number of discouraged workers

5. "Labor-force growth has, in the past, tended to reflect the economic situation. In almost all post-war recession years the participation rate fell slightly, with the result that the rate of unemployment"

- a) fell by more
- b) rose by more
- c) didn't fall by as much
- d) didn't rise by as much

6. "In fairness, the strong female job growth occurred partly because so many more women were available to work. The female participation rate rose to 55 percent from just 45 percent a decade earlier." The female participation rate is

- a) one minus the male participation rate
- b) the fraction of the labor force that is female
- c) the number of females employed expressed as a fraction of the number of females in the labor force
- d) the number of females in the labor force expressed as a fraction of the number of non-institutionalized females 16 years of age and over.

7. "The reduction in the unemployment rate which is projected to take place as a result of the budget proposals is expected to be moderated as participation rates continue to _____." Fill in the blank.

- a) rise
- b) fall
- c) fluctuate
- d) hold steady

8. "More job losses in the manufacturing sector helped pull employment down by 390,000 in November. Only the fact that the labor force _____ kept the unemployment rate steady." Fill in the blank.

- a) rose by much more
- b) fell by much more
- c) rose by approximately the same amount
- d) fell by approximately the same amount

9. "Nationally, the monthly survey of American households found 387,000 more people at work in February than in January, but many of the new jobs were only part time, the Labor Department reported." From this information we can conclude that

- a) unemployment has risen
- b) unemployment has fallen
- c) unemployment has remained constant
- d) nothing can be said about unemployment

10. "The Bureau of Labor Statistics said Friday that the country lost 190,000 jobs in August and noted that the unemployment rate would be more than two percentage points higher than a year ago if there weren't so many" Complete this clipping.

- a) part-time jobs
- b) encouraged workers
- c) people leaving the labor force
- d) homemakers entering the labor force.

11. "Even if employment continues to climb, the jobless rate will likely stay around its current level for the balance of this year, Cramer said. That's because" Complete this clipping.

- a) the labor force will shrink
- b) the extra jobs will be part-time
- c) of increases in the participation rate
- d) of an increase in discouraged workers

12. "Job creation in October was much more robust than most forecasters had predicted, but the number of people either working or looking for work increased even more sharply." From this information the unemployment rate should be

- a) rising
- b) falling
- c) steady
- d) not enough information to tell

13. "And so we find ourselves in the strange situation in which employment is rising and at the same time unemployment is rising." This could happen because

- a) too many people are retiring
- b) the participation rate is falling
- c) of an increase in the number of discouraged workers
- d) the labor force is increasing by more than employment

14. "The unemployment rate increased to 6.8%, with employment rising by a big 0.6% or 68,000 during the month and the labor force increasing by _____." The blank should be

- a) less than 68,000
- b) 68,000
- c) more than 68,000
- d) not enough information to tell

15. "The unemployment rate moved up to 7.8 per cent (seasonally adjusted) in May from April's 7.7 per cent, but not because of job losses. Indeed, employment rose by a big 0.6 per cent or 68,000 during the month. However," Complete this clipping.

- a) the participation rate fell.
- b) even more people joined the labor force
- c) the number of encouraged workers decreased
- d) the number of discouraged workers increased

16. "For example, the jobless rate fell to 5% last month, the lowest number in 2 years. But if you think it's a sign that the economy is suddenly moving up, look again." A fall in the unemployment rate may not be a sign that the economy is moving up because of

- a) more part-time jobs
- b) more former homemakers working
- c) a rise in the number of encouraged workers
- d) a rise in the number of discouraged workers

17. Suppose the labor force is 15 million, the participation rate is 75% and unemployment is 10%. If the number of discouraged workers increases by 1 million, then

- a) unemployment falls to 9%
- b) unemployment rises to 11%
- c) the participation rate falls to 70%
- d) the participation rate rises to 80%

18. If the participation rate is 75%, the unemployment rate is 10%, and the labour force is 20 million, then the number of people unemployed is

- a) 1 million b) 1.5 million c) 2 million d) not enough information to tell

19. If the non-institutionalized population 15 years of age and older is 16 million, the number of discouraged workers is 1 million, the labour force is 11 million and total employment is 9 million, then the measured unemployment rate is about

- a) 10% b) 13% c) 18% d) 25%

20. Suppose the non-institutionalized population 15 years of age and over is 25 million, the participation rate is 80%, the number of discouraged workers is one million, the number of people with full-time jobs is 16 million, and the number of people with part-time jobs is two million. From this information, the measured unemployment rate is

- a) below 9% b) between 9% and 12.5% c) between 12.6% and 16% d) above 16%

21. If the population over 15 years of age is 160 million, the number of discouraged workers is 10 million, the labor force is 110 million and total employment is 90 million, then the measured unemployment rate is

- a) less than 10% b) 10% c) greater than 10% but less than 15% d) 15% or more

22. Suppose the population over age 15 is 160 million, the number of discouraged workers is 5 million, the participation rate is 75 percent and the unemployment rate is 10 percent. How many officially unemployed are there?

- a) less than or equal to 10 million b) greater than 10 and less than 15 million
c) greater than or equal to 15 million but not more than 17 million
d) more than 17 million

23. Suppose the population over age 15 is 140 million, the participation rate is 60 percent, and the unemployment rate is 10 percent. If the number of discouraged workers increases by 2 million, the unemployment rate becomes

- a) less than or equal to 7.7% b) more than 7.7% but less than 8.7%
c) greater than or equal to 8.7% but not more than 10% d) greater than 10%

24. Suppose the population over age 15 is 150 million, the number of discouraged workers is 5 million, the unemployment rate is 10 percent and there are 90 million employed. The participation rate is

- a) less than 63% b) 63% or more but less than 70% c) 70% d) more than 70%

25. Suppose frictional unemployment is 1 percent, structural unemployment is 2 percent, cyclical unemployment is 3 percent, and unemployment due to unemployment insurance and minimum wage legislation is 4 percent. Based on this information the NRU is

- a) 3% or less b) 4%, 5% or 6% c) 7%, 8% or 9% d) 10% or more

26. Suppose the population over age 15 is 25 million, the participation rate is 80 percent, the number of people with full-time jobs is 16 million, and the number of people with part-time jobs is two million. If the number of discouraged workers increases by one million, what does the measured unemployment rate become?

- a) 5% or less b) more than 5% but less than 10%

- c) 10% or more but not more than 12% d) more than 12%

27. Suppose the population over age 15 is 150 million, the participation rate is 60 percent, and the unemployment rate is 10 percent. If the number of encouraged workers increases by 2 million, the participation rate becomes

- a) 59% or less b) greater than 59% but less than 60%
c) 60% or more, but not more than 61% d) greater than 61%

28. Suppose the population over age 15 is 150 million, the participation rate is 60 percent, and the unemployment rate is 10 percent. If the labor force grows by 3 percent and employment grows by 2 percent, what does the unemployment rate become?

- a) less than or equal to 10% b) more than 10% but not more than 10.5%
c) more than 10.5% but not more than 11% d) more than 11%

29. Suppose the CPI is calculated assuming that one-quarter of expenses is for health, transportation, and entertainment, and three-quarters for all other items. When the prices of items in the first category double and the prices of all other items quadruple, then

- a) the CPI overstates the change in the cost of living
b) the CPI understates the change in the cost of living
c) the CPI provides an accurate measure of the change in the cost of living
d) there is not enough information given to determine the CPI accuracy

30. An increase in the number of discouraged workers will

- a) decrease the measured level of unemployment
b) increase the measured level of unemployment
c) not affect the measured level of unemployment, but change the participation rate
d) have no effect on either measured unemployment or the participation rate

31. The unemployment rate fell despite 190,000 fewer jobs. This could be because of

- a) fewer teenagers looking for jobs b) an increase in structural unemployment
c) more women entering the labour market
d) elderly coming out of retirement to work in the service sector

32. A forest worker who is out of work because of low demand for lumber is said to be

- a) cyclically unemployed b) frictionally unemployed
c) structurally unemployed d) underemployed

33. People who worry that unemployment will increase in the future because we will be unable to compete in a "free-trade" international environment are expressing a concern about future

- a) seasonal unemployment b) cyclical unemployment
c) frictional unemployment d) structural unemployment

34. A person is considered unemployed if that person:

- a) does not have a job b) is not now working but has previously held a job
c) does not have a job but is actively searching for a job
d) has part-time employment, but wants full-time employment

35. Other things equal, an increase in the number of "discouraged workers" will
a) destroy jobs b) raise the participation rate
c) decrease the size of the labour force d) raise the measured unemployment rate
36. Other things equal, an increase in the number of "encouraged workers" will
a) create jobs b) lower the participation rate
c) decrease the size of the labour force d) increase the measured unemployment rate
37. An increase in the number of encouraged workers
a) raises the unemployment rate and the participation rate
b) lowers the unemployment rate and the participation rate
c) lowers the unemployment rate and raises the participation rate
d) raises the unemployment rate and lowers the participation rate
38. One cause of structural unemployment is due to
a) workers looking for better jobs b) geographical mobility of the labour force
c) a decline in the economy's total production
d) automation displacing workers from their jobs
39. Suppose the non-institutionalized population over age 15 is 200 million, 100 million of whom are female, the labour force is 150 million, 60 million of whom are female, and the number of people employed is 120 million, 40 million of whom are female. The female participation rate is
a) 30% b) 40% c) 50% d) 60%
40. "This is the critical assumption in the unemployment rate projection. If participation rates turn out to be higher, the unemployment rate will be _____, and if participation rates turn out to be lower, the unemployment rate will be _____." The blanks are best filled with
a) higher, unaffected b) higher, lower c) lower, unaffected d) lower, higher
41. "In the U.S. or Britain, economic recoveries put people back to work relatively quickly. But Germany is bogged down by high labor costs and other structural factors that discourage hiring. So the recent unemployment rate of 11.4% is not likely to fall by much in the near future." Economists would refer to this situation as a high
a) natural rate of unemployment b) cyclical rate of unemployment
c) frictional rate of unemployment d) structural rate of unemployment
42. Suppose the unemployment rate is 8%, and the labor force is 20 million. If the number of encouraged workers rises by 100,000, the unemployment rate becomes
a) 7% or less b) between 7% and 8% c) 8% d) greater than 8%
43. "Though President Clinton has called for a global summit on unemployment, neither the president nor his critics have clearly formulated the most important economic question raised by his economic proposals. Should the U.S., like the European Community, accept an ever higher _____ as the cost of expanding social programs." The blank is best filled with
a) interest rate b) inflation rate c) unemployment rate d) level of inequality

44. "The problem first appeared in the 1920s after Britain instituted the "dole," or unemployment benefit. Prices fell after a tremendous wartime inflation. But the dole, which was fixed in nominal terms, stopped money wages from adjusting. For the first time, Britain suffered permanent and high unemployment." The dole could cause unemployment by

- a) pulling down wages
- b) requiring higher taxes
- c) creating incentives not to work
- d) increasing structural unemployment

45. "In advocating expanded unemployment benefits, President Clinton observed that 'All the European countries have higher unemployment rates than we do but also stronger support systems for the unemployed.' " This argument supporting expanded unemployment benefits can best be countered by arguing that

- a) we can not afford stronger support systems
- b) stronger support systems have caused higher unemployment
- c) we have low unemployment and so don't need stronger support systems
- d) higher unemployment has forced Europeans to develop stronger support systems

46. "Federal government changes to the employment insurance program have caused the Atlantic region to suffer from two conflicting problems simultaneously – high unemployment and a labor shortage." This paradoxical situation could come about because the employment hours required for benefit eligibility were _____ and unemployment benefits were _____. This blanks are best filled with

- a) decreased; decreased
- b) decreased; increased
- c) increased; decreased
- d) increased; increased

47. "British Columbia's unemployment rate increased to 4.3 percent in September even though the number of jobs remained steady." The unemployment rate could increase despite the number of jobs remaining steady because

- a) some of the jobs became part-time jobs
- b) more people were looking for work
- c) fewer people were employed
- d) they changed the way unemployment is measured

48. "Although there was stellar job growth in 2002, it had little impact on the jobless rate because" The best way to complete this clipping is

- a) unemployment rose
- b) the jobs were all part time
- c) fewer people wanted these jobs
- d) the participation rate increased

49. "US employers went on a hiring spree in October, adding 337,000 new jobs, many of them for hurricane cleanup. Despite this the Labor Department reported a rise in the unemployment rate from 5.4 to 5.5 percent. The breakdown was as follows: the jobless rate for black people jumped to 10.7 from 10.3 percent; the rate for Hispanics fell to 6.7 from 7.1 per cent, the rate for teenagers grew to 17.2 from 16.6 per cent, and the rate for

whites held at 4.7 percent.” How would you explain the rise in the unemployment rate in the face of so many new jobs.

- a) the new jobs were mostly part-time
- b) less than 337,000 people joined the labor force
- c) 337,000 people joined the labor force
- d) More than 337,000 joined the labor force

Answers: 1c 2c 3c 4c 5d 6d 7a 8d 9d 10c 11c 12a 13d 14c 15b 16d 17c 18c 19c 20b 21d 22b 23b 24b 25c 26b 27d 28c 29a 30a 31a 32a 33d 34c 35c 36d 37a 38d 39d 40b 41a 42d 43c 44c 45b 46b 47b 48d 49d

Chapter 5: The Role of Aggregate Demand

1. "Under present circumstances there is such a thing as a 'free lunch'. In effect, all of the ingredients of that lunch are already there - the people who want to work, the factories and equipment standing idle, and the raw materials not being used. It is just a question of injecting a little spending power to prevent the free lunch from going to waste." What would happen if this policy of injecting a little spending power were undertaken without the ingredients listed above?

- a) higher inflation
- b) higher tax rates
- c) higher unemployment
- d) more discouraged workers

2. "Most economists these days are preaching that consumers had better start spending. Fears of unemployment have curtailed consumer spending and starved the federal government of tax revenues needed to reduce the deficit." Does the fact that unemployment fears curtail consumer spending serve to stabilize or destabilize the economy?

- a) stabilize because the lower consumer spending prevents inflation
- b) destabilize because the lower consumer spending makes unemployment worse
- c) destabilize because the lower consumer spending offsets the multiplier process
- d) stabilize because the lower consumer spending reinforces the multiplier process

3. "Changes in inventories go a long way, for instance, toward explaining why first-quarter real GNP was ahead of a year earlier by a meagre 1.7 percent." What must have been happening to inventories during the first quarter?

- a) rising because of unexpectedly-high output
- b) falling because of unexpectedly-low output
- c) rising because of unexpectedly-low aggregate demand
- d) falling because of unexpectedly-high aggregate demand

4. "Economists expect to see some further liquidation of inventories this quarter, but at a slower rate. And that change from rapid to slow - from negative to less negative - shows up as a plus for the economy." This is a plus for the economy because

- a) it means that output is increasing
- b) it means that aggregate demand is increasing
- c) businesses are more profitable with less inventories

d) it means that investment in inventories should increase

5. "We saved 17 percent of our disposable income during the recession, the highest rate since World War II. The level of savings has fallen off since then to less than 10 percent of disposable income." What effect would a higher savings rate have on the recession?

- a) it would not affect the recession
- b) it would make the recession less severe
- c) it would make the recession more severe
- d) it would have no predictable effect on the recession

6. "The only other potential bright spot observers spy on the horizon is lower personal tax rates and higher take-home pay under the federal tax reform package, that will begin in July." This is viewed as a bright spot because

- a) people like lower taxes
- b) lower taxes will combat inflation
- c) lower taxes will stimulate the economy
- d) lower taxes lower the income level through the multiplier process

7. "But in a loose sense, we are all Keynesians now - all of us, at any rate, who reject the notion that a sick economy heals itself by 'natural' recuperative powers, without government action." This suggests that faced with a sick economy Keynesians would recommend

- a) doing nothing
- b) a stimulating fiscal policy
- c) a stimulating monetary policy
- d) either or both of b) or c) above

8. "The report attributed the strength of the recovery during the first three months of this year to increased consumer spending and residential construction, as well as a reduced rate of inventory liquidation." A reduced rate of inventory liquidation contributes to the recovery because it is caused by

- a) lower aggregate supply which increases income and causes multiplier effects
- b) higher aggregate supply which increases income and causes multiplier effects
- c) higher aggregate demand which stimulates the economy and causes multiplier effects
- d) lower aggregate demand which stimulates the economy and causes multiplier effects

9. "There have been times when the federal government has kept pumping fiscal stimulus into the economy when it was already growing vigorously and did not need the boost. The result was" Complete this clipping.

- a) higher taxes
- b) higher inflation
- c) higher unemployment
- d) more discouraged workers

10. "Manufacturers ended last year on a strong note with both shipments and orders rising to record levels in December. At the same time there was an ominous buildup of inventories, which also rose to a record level." The buildup in inventories is ominous because it suggests that

- a) inflation is heating up
- b) unemployment will develop
- c) inventory taxes will be increased
- d) encouraged workers will increase

11. "When the news of Wednesday's numbers on GDP was made public, stocks and bonds immediately rose and the U.S. dollar strengthened. Then, when analysis of the numbers came in, the markets went into reverse. The reason was that the greater part of

the improvement in the quarter - \$33.7 billion out of a total GDP advance of \$39.2 billion - came from additions to business inventories." Markets went into reverse upon learning about the additions to inventories because it suggested that

- a) output had risen, raising inflation fears
- b) output had fallen, raising unemployment fears
- c) aggregate demand had risen, raising inflation fears
- d) aggregate demand had fallen, raising unemployment fears

12. "But as consumer spending slackened, stocks began to pile up. So an inventory correction is underway, and it will reduce this quarter's real GDP by more than 10 percent at an annual rate." This inventory correction will come about because of

- a) lower output causing inventories to fall to what firms desire
- b) higher output causing inventories to rise to what firms desire
- c) lower aggregate demand causing inventories to rise to what firms desire
- d) higher aggregate demand causing inventories to fall to what firms desire

13. "What cannot be done, various reformers in the U.S. notwithstanding, is to impose on any government the obligation to balance its budget annually. Consider the consequences. If it did work, it would introduce a major destabilizing element." Requiring a balanced budget would be destabilizing because a movement towards recession would

- a) increase unemployment, prompting a decrease in tax rates or an increase in government spending, both of which would create inflation
- b) increase unemployment, prompting an increase in tax rates or a decrease in government spending, both of which would create inflation
- c) decrease tax receipts causing a budget deficit, requiring an increase in tax rates or a decrease in government spending both of which would make the recession worse
- d) decrease tax receipts causing a budget surplus, requiring an increase in government spending or a decrease in tax rates, both of which would make the recession worse

14. "Adam Smith said 200 years ago: 'What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom.' With the advent of a 'Keynesian revolution' since World War II, principles of fiscal responsibility were abandoned - in fact, they were reversed. The message of Keynesianism might be summarized as: 'What is folly in the conduct of a private family may be prudence in the conduct of the affairs of a great nation.'" The folly referred to here is

- a) deficit spending
- b) inflationary spending
- c) crippling taxation
- d) forced labor

15. "The U.S. Department of Commerce has estimated that if U.S. manufacturers use metric measures, their increased ability to compete on world markets should increase exports by about \$600 million and thus benefit the U.S. economy by between \$1.2 billion and \$1.8 billion." These numbers suggest that

- a) the multiplier is between 2 and 3
- b) imports should increase by between \$1.2 and \$1.8 billion
- c) exports are unlike other kinds of spending in terms of their multiplier impact
- d) it takes between \$1.2 and \$1.8 billion increase in income to generate a \$600 million increase in exports

16. "Some claim that the fact that both deficits and unemployment have increased together since 1979 proves that fiscal stimulus doesn't work. It's true that our jobless rate rose from 1979 to 1984 while the federal deficit doubled as a percentage of GDP. But the inference about the ineffectiveness of fiscal stimulus is nevertheless wrong, because"

Complete the argument about to be developed here

- a) the deficits were caused by the recession
- b) the government has been using policy to combat inflation
- c) the unemployment was due to decreases in the participation rate
- d) the unemployment was due to a fall in the natural rate of unemployment

17. "Counter-cyclical policy is about filling in holes and shaving off peaks, exactly what John Maynard Keynes prescribed." Exactly what filling in holes and shaving off peaks did Keynes prescribe?

- a) raising taxes in recessions and decreasing government spending in booms
- b) cutting taxes in recessions and increasing government spending in booms
- c) decreasing government spending in recessions and increasing it in booms
- d) increasing government spending in recessions and decreasing it in booms

18. "The French economy took a nosedive after the Socialist government was elected in 1981. In reaction, Mr. Mitterand's government shortened the workweek, raised the minimum wage and increased various social benefits, whereupon unemployment actually increased further." This happened because

- a) the NRU increased
- b) of the multiplier process
- c) aggregate demand decreased
- d) the social benefits were not appreciated

19. "Business inventories could have accumulated because sales fell below expectations. On the other hand, firms may have stockpiled inventories because they anticipated a surge in sales. The distinction is important because 87 percent of the stronger-than-expected 3.4 percent annualized growth in real GDP in the second quarter came from inventory accumulation. Those going with the first explanation are forecasting _____, while those who go with the second explanation are forecasting _____." Fill in the blanks.

- a) a recession; a boom
- b) a boom; a recession
- c) inflation; unemployment
- d) a drop in inventories; a rise in inventories

20. "For Canada, the demand pressures generated by the U.S. tax cuts and the spillover effects of increased U.S. defense spending will push the Canadian economy further into an excess demand situation." Why will this policy affect Canada?

- a) It shouldn't because Canada is a different country
- b) American imports will rise, increasing Canadian exports
- c) Canadians will flock to the U.S., decreasing aggregate supply in Canada
- d) Canada will increase its defense spending to counteract the higher U.S. defense spending

21. "I promise to reduce the federal deficit. That means reducing federal expenditures and, if necessary, increasing taxes. Under present conditions of full employment and steady prices, we can afford to bear the burden of this debt now instead of passing it on to

our grandchildren." If the policies of this politician were adopted, what effects would be expected while these policies were being implemented?

- a) higher inflation
- b) increased imports
- c) higher rates of economic growth
- d) increased unemployment and idle capacity

22. "Although initially the news looked good, with growth of 4.2 per cent in the final three months of the year, closer examination showed a sharp drop in consumer spending and a large expansion in inventories." This news is not good because

- a) firms will cut output to lower inventories
- b) higher inventories will decrease aggregate demand
- c) although aggregate demand is higher by 4.2 per cent, this is not sustainable
- d) a drop in consumer spending decreases saving which lowers aggregate demand

23. "For the people around here this extra million dollars of government spending means 42 direct jobs and, depending on the employment multiplier you prefer, another 120 or 160 indirect jobs. In the bush. On the booming grounds. In the drugstore." Per million dollars, the magnitude of the employment multiplier is

- a) 42
- b) above 42 but less than 162
- c) between 162 and 202
- d) more than 202

24. "The extent of the downturn surprised many analysts. According to the Council, the real gross domestic product fell at an annual rate of 4 percent. If an apparently unplanned buildup of inventories is taken into account, the rate of decline is estimated at 7.6 percent." What has happened here?

- a) Both GDP and aggregate demand have fallen by 4%
- b) Both GDP and aggregate demand have fallen by 7.6%
- c) GDP has fallen by 7.6% and aggregate demand has fallen by 4%
- d) GDP has fallen by 4% and aggregate demand has fallen by 7.6%

25. "A \$4 billion tax cut was accompanied by a \$6 billion increase in consumer spending in the same year." The most probable reason why consumer spending increased by more than taxes were reduced is that

- a) the tax cut reduced interest rates which in turn stimulated consumer spending by others
- b) lower taxes required lower government spending which in turn encouraged private spending by others
- c) spending by those with higher take-home pay in turn generated additional production and spending by others
- d) the tax cut induced more transfer payments which in turn caused an increase in consumer spending by others

Consider an economy in which the current level of income is \$600b, "the" multiplier is 4, the marginal tax rate is 20%, the current budget deficit is \$30b.

26. To increase income to \$650b we require an increase in government spending of

- a) less than \$10b
- b) between \$10b and \$15b
- b) c) between \$15b and \$20b
- d) over \$20b

27. As a result of this policy the budget deficit will become

- a) less than or equal to \$30b
- b) between \$30b and \$35b

- c) between \$35b and \$40b d) \$40b or greater

28. From the data in Table 1, when the level of income is 220,
 a) inventories will be rising b) inventories will be falling
 c) inventories will be steady d) insufficient data to determine inventory behavior

29. From the data in Table 1 the equilibrium level of income
 a) is less than 220 b) is 220 c) is more than 220 d) could be any level

30. Using the data in Table 1, by how much should the level of income have increased after two rounds of the multiplier process if the economy begins at its equilibrium position and increases government spending by 40?
 a) 40 b) 68 c) 70 d) 73

Table 1. For each level of output are shown the resulting levels of the elements of aggregate demand.

Output	Consumption	Investment	Government Spending	Net Exports
100	80	15	15	6
140	110	20	15	4
180	140	25	15	2
220	170	30	15	0
260	200	35	15	-2
300	230	40	15	-4

31. If "the" multiplier is 5 and income increased by \$65 billion, the increase in autonomous spending must have been
 a) \$11 b) \$13 c) \$325 d) \$0.077

32. If "the" multiplier is 4 and the government wants to increase the level of income by \$30 billion, it should increase government spending by
 a) \$4 b) \$7.5 c) \$30 d) \$120

33. Suppose that the income multiplier with respect to government spending is 2.5 and the marginal tax rate is 25 percent. If the government increases spending by 8 billion dollars, the budget deficit will
 a) decrease or be unaffected b) increase by \$3b or less
 c) increase by more than \$3b but less than \$8b d) increase by \$8b or more

34. Suppose the current level of income is \$600 billion, "the" multiplier is 4, the marginal tax rate is 20 percent, and the current budget deficit is \$20 billion. If government spending is increased to raise income to \$630b, once equilibrium is attained the budget deficit will be
 a) \$20b or less b) more than \$20b but less than \$22b
 c) at least \$22b but less than \$27b d) \$27b or more

Suppose "the" multiplier is 4 and the government increases spending by \$5 billion but the economy is at full employment at nominal income level \$600 billion, so that an increase in government spending elicits price increases rather than output increases.

35. Nominal income and real income will increase by
 a) \$20b and zero, respectively b) \$20b and \$20b, respectively
 c) zero and zero, respectively d) zero and \$20b, respectively

36. The price level will increase by
 a) 2% or less b) more than 2% but not more than 3%
 c) more than 3% but not more than 4% d) more than 4%

Suppose that last year consumption was \$570 billion, tax receipts were \$240 billion, and income was \$900 billion. The corresponding numbers for this year are \$600 billion, \$250 billion and \$950 billion.

37. The MPC (marginal propensity to consume out of disposable income) is
 a) 0.7 or less b) more than 0.7 but not more than 0.8
 c) more than 0.8 but not more than 0.9 d) more than 0.9

38. The marginal tax rate is
 a) 20% or less b) more than 20% but not more than 23%
 c) more than 23% but not more than 26% d) more than 26%

39. Suppose the government has decided to increase spending by \$5 billion to buy some helicopters. To prevent this action from having any impact on GDP, taxes must be
 a) cut by \$5 billion b) increased by \$5 billion
 c) increased, but by less than \$5 billion d) increased, but by more than \$5 billion

40. Which of the following policies would a Keynesian expect to produce the largest increase in income?
 a) a tax cut of 200 b) an increase in transfer payments of 200
 c) an increase in government spending of 200
 d) an increase in both taxes and government spending of 200

41. "The" multiplier definitely becomes bigger if
 a) the MPC (marginal propensity to consume) and the MPM (marginal propensity to import) become bigger
 b) the MPC and the MPM become smaller
 c) the MPC becomes bigger and the MPM becomes smaller
 d) the MPC becomes smaller and the MPM becomes bigger

42. If everyone is forced to pay an extra \$100 in taxes each year, "the" multiplier
 a) is unchanged and income falls b) becomes smaller and income falls
 c) becomes larger and income falls d) becomes larger and income rises

43. If everyone is given a \$100 reduction in their taxes, "the" multiplier
 a) is unchanged b) becomes larger c) becomes smaller

d) not enough information to tell

44. Suppose an economy at full employment begins to experience a fall in inventories. Which policy reaction is most appropriate?

- a) increase taxes
- b) increase transfer payments
- c) increase the money supply
- d) increase government spending

45. Equilibrium GDP cannot be when total spending exceeds output because

- a) firms will cut prices to move the excess inventories
- b) firms will notice that inventories are piling up and will cut back on production levels
- c) firms will lay off workers to cut costs and GDP will move to a lower equilibrium level
- d) firms will notice that inventories are being depleted and will step up production to meet the higher demand

46. Which of the following will tend to increase the size of "the" multiplier?

- a) a higher marginal tax rate
- b) a higher marginal propensity to import
- c) a higher marginal propensity to consume
- d) a higher level of government spending

47. If you know that investment is quite volatile and you would prefer to see the economy with smaller rather than larger swings in economic activity, then

- a) you would prefer a large MPC
- b) you would prefer a small MPC
- c) the value of the MPC is not relevant because the problem is investment behavior
- d) the value of the MPC is not relevant because policy authorities can smooth out cycles with appropriate policy action

48. A conservative who was concerned with the growth in government but who believed in the Keynesian concept of demand management would most likely support which of the following expansionary policies

- a) a decrease in taxes
- b) an increase in taxes
- c) a decrease in government spending
- d) an increase in government spending

49. Suppose that in a period of sluggish growth, there is a debate on whether to stimulate the economy by means of a tax cut or an increase in government spending. In the short run, a tax cut, as contrasted with an increase in government spending, is

- a) equally powerful on a per dollar basis, favoring private over public spending
- b) not quite as powerful on a per dollar basis, favoring private over public spending
- c) equally powerful on a per dollar basis, and neutral between private and public spending
- d) not quite as powerful on a per dollar basis, and neutral between private and public spending

50. A stimulating dose of fiscal policy can be applied either by increasing government spending or by decreasing taxes. For most people the main reason for preferring one to the other is

- a) a belief that one is easier to do than the other
- b) a belief that one is faster to enact than the other
- c) a belief that one has a larger multiplier effect than the other
- d) a subjective preference for larger or smaller government activity

51. "Analysts point out, however, that production schedules for December were planned several months in advance, and were likely set before consumer spending began to show signs of weakness. Although in any given month a big rise in production coupled with weak consumer spending isn't a problem, if it happens repeatedly inventories will _____, and factories will _____." The blanks are best filled with

- a) fall; increase production b) fall: decrease production
c) rise; increase production d) rise; decrease production

52. "The extent to which the economy slows depends, in part, on inventories. Businesses added \$10.8 billion to their stockpiles in the fourth quarter. It's unclear whether that buildup was voluntary or involuntary." If the buildup was involuntary we can expect

- a) higher prices b) layoffs c) increased output d) higher employment

53. "The trend probably will continue through the autumn, analysts said, as auto makers continue trying to keep _____ in check through a mix of _____ and sweetened cash rebates." Fill in the blanks.

- a) employment; increased output b) inventory; lower output
c) employment; lower output d) inventory; increased output

54. "When the yen went through the roof early in the year we all expected it to produce bad news later on. Well, surprise surprise, here it is." This produces bad news later for Japan because the higher yen

- a) increases inflation b) prompts the central bank to increase interest rates
c) increases the Japanese natural rate of unemployment.
d) reduces exports which through a multiplier effect decreases income

55. "The problem is that economists have been underestimating the impact of rising asset values on consumer behavior." This suggests that economists should be including

- a) wealth as a determinant of consumption
b) the prices of assets when measuring inflation
c) spending on the stock market as part of consumption
d) capital gains taxes when computing disposable income

56. Suppose that an increase in GDP of \$100 increases taxes by \$30, imports by \$12, consumption by \$60, and investment by \$2. After three rounds of the multiplier process, by how much will an increase in government spending of \$2,000 have increased income?

- a) \$2,000 or less b) more than \$2,000 but not more than \$3,000
c) more than \$3,000 but not more than \$4,000 d) more than \$4,000

57. "Of course, if Washington needed less cash it would undoubtedly ease the strain on the states and the corporate sector." This strain happens because

- a) consumers are crowded out b) higher interest rates are costly
c) higher taxes are difficult to pay
d) higher government spending sets the multiplier in motion

58. "There are enough programs so that the federal deficit will swell as existing programs are maintained while tax revenues fall as a result of the weak economy." These two phenomena

- a) decrease the multiplier
- b) increase productivity
- c) destabilize the economy
- d) help balance the budget

59. "The bang from a buck of direct government spending - say, highway construction - is far greater than the punch from a tax cut of equal dollar magnitude." This happens because

- a) some of the taxes are avoided
- b) a tax cut only increases aggregate demand by the marginal propensity to save times the tax cut
- c) a tax cut only increases aggregate demand by the marginal propensity to consume times the tax cut
- d) higher government spending sets the multiplier in motion whereas a tax cut does not

60. "Clinton has promised to get the economy moving strongly again but if that requires increased government spending, financial markets may insist on an interest rate premium in anticipation of problems funding an even larger U.S. public debt. And those higher money costs could offset any benefit of higher government spending." This offset would happen because higher money costs would cause

- a) taxes to rise
- b) inflation to rise
- c) unemployment to fall
- d) aggregate demand to fall

61. "The slack exists, of course, because people continue to save even when the private sector demand for loans ebbs away. And they tend to save more, not less, in scary times." The phenomenon referred to in the second sentence acts as

- a) a destabilizer
- b) an automatic stabilizer
- c) a consumption booster
- d) a crowding out mechanism

62. "A second reason for questioning the employment-generating abilities of the deficit involves how consumers respond to an increase in government borrowing. Rational consumers realize that a higher deficit now means higher taxes in the future. If people" Complete this clipping.

- a) react by buying imports, aggregate demand and thus employment falls
- b) become discouraged workers because of future higher taxes, employment falls
- c) consume more now to avoid the future higher taxes, aggregate demand and thus employment falls
- d) save more now to be able to pay the future higher taxes, aggregate demand and thus employment falls

63. "This is the "crowding out" theory: Increased government borrowing crowds household and business investment out of limited savings, driving up _____, but not raising total demand." Fill in the blank.

- a) taxes
- b) inflation
- c) interest rates
- d) employment

64. Suppose the economy is in recession and the government increases its spending by \$10 billion but will not allow a deficit so at the same time it increases taxes by \$10 billion. As a result of this the level of income

a) rises b) falls c) is unchanged d) changes in an unpredictable direction

65. Which of the following policies would a Keynesian expect to produce the largest increase in income?

- a) a tax cut of \$200
- b) an increase in transfer payments of \$200
- c) an increase in government spending of \$200
- d) a "balanced budget" increase in government spending of \$200.

66. According to Keynesian theory, how will increasing government spending when unemployment is 10% have a different effect from a similar increase when unemployment is 5%?

- a) At 10%, it is more likely to increase prices than real output.
- b) At 5%, it is more likely to increase real output than prices.
- c) At 10% it is more likely that it will require a sacrifice of private goods.
- d) At 5% it is more likely that it will require a sacrifice of private goods.

67. "The" multiplier is higher if

- a) the MPC is lower
- b) the tax rate is higher
- c) spending is less sensitive to the interest rate
- d) spending is more sensitive to the interest rate

68. Crowding out causes "the" multiplier to

- a) become larger
- b) become smaller
- c) become unstable
- d) remain unchanged

69. Which of the following should lead to a rise in economic activity?

- a) a decrease in inventories
- b) a decrease in consumption
- c) an increase in the interest rate
- d) an increase in the marginal tax rate

70. Suppose there is a tax increase. Because during the economy's reaction to this the interest rate becomes

- a) higher, the decrease in GDP is larger than if the interest rate had not changed
- b) higher, the decrease in GDP is smaller than if the interest rate had not changed
- c) lower, the decrease in GDP is larger than if the interest rate had not changed
- d) lower, the decrease in GDP is smaller than if the interest rate had not changed

71. Crowding out involves a reduction in

- a) I (investment demand)
- b) I and C (consumption demand)
- c) I, C, and G (government demand)
- d) I, C, G and X (export demand)

72. A decision by the government to increase its spending by \$2 billion will have the largest impact on aggregate demand when it is financed by selling bonds to

- a) the public
- b) the commercial banks
- c) the central bank
- d) it does not matter who buys the bonds

"First, a rise in the debt/GDP ratio means that the current generation is consuming goods and services at the expense of future generations. We are in effect stealing from the future by consuming more than we can produce."

- b) the Olympic games when the economy is in a recession
- c) a railroad spur line to a coal-rich area when the economy is in recession
- d) a railroad spur line to a coal-rich area when the economy is fully employed

81. An increase in our borrowing from foreigners

- a) is usually caused by a fall in our interest rate
- b) is unquestionably a burden on future generations
- c) happens when our bond prices are relatively high
- d) lets current-generation citizens obtain more than full-employment output

82. "Research suggests that when the ratio of public debt to GDP is high, the multiplier effect of fiscal stimulus is low." The logic here is that

- a) the government can't increase government spending by very much
- b) people don't spend because they are worried about paying future taxes
- c) the statement is wrong – fiscal stimulus via lower taxes is strong
- d) the statement is wrong – the multiplier should be high

83. "Last year U.S. taxpayers saved virtually all the money they got through a federal tax cut. And the recent (2008-9) spike in the personal savings rate supports Ricardo's theory." This behavior causes the multiplier to become

- a) bigger b) smaller c) unreliable d) no change

84. "Their reluctance to spend, according to Ricardo, stems from a lack of faith in the government's ability to manage stimulus, and a belief that they will eventually be hit by" This clipping is best completed with

- a) higher interest rates
- b) higher taxes
- c) lower government spending
- d) foreign borrowing

85. "Named after the writings of David Ricardo in the early 1820s, the theory suggests that stimulus spending is doomed to failure because"

This clipping is best completed with

- a) the stimulus dollars are saved, not spent
- b) of the way the stimulus spending is financed
- c) the stimulus should have been through lower taxes
- d) it is invariably spent on the wrong things.

86. "There is growing optimism that the economy is heading for recovery, based on a slowing decline in inventories." A slowing decline in inventories creates optimism because it results from

- a) higher aggregate demand or lower aggregate supply
- b) higher aggregate demand or higher aggregate supply
- c) lower aggregate demand or lower aggregate supply
- d) lower aggregate demand or higher aggregate supply

87. "The economy is already running a negative output gap of 6%." A negative output gap is a situation in which full employment aggregate supply is

- a) bigger than aggregate demand
- b) smaller than aggregate demand
- c) bigger than aggregate supply
- d) smaller than aggregate supply

88. "Movement out of the 2008-9 recession will be slowed because the big deficits used to stimulate the economy will increase the public debt dramatically." A larger public debt will slow the recovery because

- a) the interest rate will fall, lowering corporate investment spending
- b) people will save to smooth consumption in anticipation of higher taxes
- c) the government will be unable to maintain its higher level of spending
- d) none of the above

89. "Hampered by the 2008 downturn, Americans have boosted the U.S. savings rate from zero to 5 percent in the past year. They have a long way to go to match China, however, where the current savings rate is in excess of 30 percent!" What is the most likely cause of the increase in the U.S. saving rate?

- a) competition with China
- b) higher investment in the U.S.
- c) a higher U.S. interest rate
- d) fear of unemployment and anticipation of higher future taxes

90. "The hero of every major recovery since the end of the Second World War, the American shopper is ratcheting down spending amid the brutal housing and financial crisis. As the mighty American consumer saves, the U.S. is looking to China as it economic savior." China could be the savior of the American economy by

- a) financing the U.S. government deficit
- b) financing U.S. investment spending
- c) buying American exports
- d) sending foreign aid

91. "Keynesian theory says stimulate by lowering taxes. But what do you think a typical worker, given a thousand-dollar tax break during a major recession, will likely do with it?" The best answer to this rhetorical question is

- a) divide it equally between spending and saving
- b) spend most of it and save the rest
- c) save most of it and spend the rest
- d) use it as a down payment on a house

92. "In a recent interview the central bank Governor said that the paring back of inventories should" This clipping is best completed with

- a) Worsen the recession but lead eventually to an economic recovery
- b) Worsen the recession and kill any future recovery
- c) Push us out of recession and maintain an economic recovery
- d) Push us out of recession temporarily but lead eventually to a long-term recession.

93. "Businesses are quickly moving to cut inventory levels, a key development." Cutting inventory levels will

- a) Push the economy toward recession.
- b) Stimulate the economy.
- c) Complement fiscal policy.
- d) Make firms more efficient

94. "On the face of it, Zimbabwe's finance minister should be the envy of his counterparts around the world. How many of them could virtually double public spending without raising taxes?" This happened because the higher spending was financed by

- a) printing money
- b) foreign direct investment
- c) foreign aid
- d) an increase in the tax base

95. "The White House recently said that without the tax cuts in 2001 and 2003, there would currently be 1.5m fewer jobs in the US." The logic for this claim is that a multiplier process increased employment because the tax cuts

- a) increased consumer and investment spending
- b) financed an increase government spending
- c) decreased consumer and investment spending
- d) forced a decrease in government spending

96. "Economists said that even after taking hurricane and strike distortions into account, industrial production data signaled that manufacturers were bracing for tougher conditions." What must have happened in the industrial production data here?

- a) an increase as producers built up inventories
- b) a decrease because producers forecast lower demand
- c) an increase because producers forecast higher demand
- d) a decrease because of higher inventory due to the hurricane and strike

97. "Already, the electronics retailer Circuit City has filed for bankruptcy, and General Motors has said that it is in danger of running out of cash. If the consumer slump continues, there is a potential for a dangerous feedback loop, in which spending cuts and layoffs reinforce each other." How do economists refer to this phenomenon?

- a) an iterative process
- b) a circular story
- c) a multiplier process
- d) a vicious circle

98. "But the stimulus package under discussion would bring no more than \$150 billion in new government spending. The difference between a good year for consumer spending and a really bad one is about \$400 billion." What is the point being made here?

- a) the multiplier process will save us
- b) higher government spending creates more stimulus than an equal increase in consumption spending
- c) the increase in government spending isn't big enough
- d) fiscal policy is useless

99. "These statistics indicate a combination of a significant upward revision to GDP growth, a downward revision of the output gap, and stronger-than-expected inflation data." The output gap is the difference between

- a) aggregate supply and aggregate demand

- b) potential output and current output
- c) full employment and actual employment
- d) tax requirements and tax receipts

”So it looks like the U.S. economy is in the not-too-hot, not-too-cold sweet spot: it expanded at an estimated 3.4 percent annualized rate, and the core inflation measure eased to 1.8 percent. But check the details: A reduction in inventories in the quarter sliced 2.3 percentage points off the GDP growth number.” Hint: this is tricky – a reduction in inventories cannot take points off GDP growth because the GDP measure is adjusted for inventory change. The next two questions refer to this clip.

100. What is happening here?

- a) the economy is slowing down
- b) aggregate demand exceeds aggregate supply
- c) actual growth is 1.1 percent
- d) actual growth is 5.7 percent

101. By what percent did aggregate demand grow here?

- a) 3.4 b) 5.7 c) 1.1 d) not enough information to tell

102. ”The International Monetary Fund said Spain’s economy is likely to contract by “at least” 1% in 2009, and called on the government to” This clipping is best completed with

- a) increase government spending
- b) increase taxes
- c) balance its budget
- d) decrease unemployment benefits

”Efforts to encourage spending during a downturn are not usually successful because _____, and so an increase in government spending would have to be exceptionally large.” The following two questions refer to this clip.

103. The blank is best filled with

- a) taxes are too high
- b) the budget needs to be balanced
- c) people are saving because of uncertainty
- d) people are saving to enhance long run growth

104. During a downturn the multiplier is

- a) high because extra stimulus is needed
- b) low because there is too much stimulus
- c) high because the increase in government spending is large
- d) low because the MPC shrinks

105. “Everyone tightens their belts during a crisis, even though they may know that collectively this will lead to economic disaster.” Tightening belts means

- a) spending less on food
- b) spending less on clothing

- c) higher taxes
- d) higher saving

106. "George W. Bush's \$168 billion tax rebate plan of February of 2008 was designed to stimulate the U.S. economy, but it didn't work, and so instead" The tax cut didn't work because

- a) it wasn't big enough
- b) people chose to save the tax cut
- c) it created a budget deficit
- d) other policies offset it

Answers: 1a 2b 3b 4a 5c 6c 7d 8b 9b 10b 11d 12a 13c 14a 15a 16a 17d 18a 19a 20b 21d 22a 23c 24d 25c 26b 27b 28a 29a 30d 31b 32b 33b 34b 35a 36c 37b 38a 39d 40c 41c 42a 43a 44a 45d 46c 47b 48a 49b 50d 51d 52b 53b 54d 55a 56c 57b 58a 59c 60d 61a 62d 63c 64a 65c 66d 67c 68b 69a 70d 71d 72c 73b 74d 75b 76d 77c 78d 79c 80a 81d 82b 83b 84b 85a 86b 87c 88b 89d 90c 91c 92a 93a 94a 95a 96b 97c 98c 99b 100b 101b 102a 103c 104d 105d 106b

Chapter 6: The Supply Side

1. "He favors a slow recovery, for example, partly because the 'natural rate of unemployment' may turn out to be higher than anyone thinks." The rationale behind the suggestion that policy should push the economy out of recession slowly rather than quickly is that

- a) if the natural rate of unemployment is overestimated inflation could be created
- b) if the natural rate of unemployment is underestimated inflation could be created
- c) if the natural rate of unemployment is overestimated a recession could be created
- d) if the natural rate of unemployment is underestimated a recession could be created

2. "There is little doubt that the key reason for this slide toward ever more inflation was an effort by public policy in most countries to achieve and maintain more output and employment from their economies than was consistent with price stability." This most likely has resulted from

- a) a rise in taxes
- b) an underestimation of the NRU
- c) an increase in government spending
- d) an overestimation of price increases by workers

3. "The gap between actual and potential output for this year is estimated to be about 8% of potential output. Wholesale prices are virtually unchanged from one year ago. Unemployment is 9%, the same level as 6 months ago." Which of the following stabilization policies would be most appropriate?

- a) a higher minimum wage
- b) increases in income taxes
- c) an increase in government spending
- d) reductions in unemployment insurance benefits

and secure employment, access to quality, affordable medical care, and a good education for their children - then society as a whole is richer." This refers to the trade-off between

- a) equity and efficiency
- b) consumption and saving
- c) inflation and unemployment
- d) taxes and government spending

11. "One striking challenge came from "supply-side" economists who contended that the sheer waste and perverse incentives associated with high tax rates created opportunities to cut tax rates without cutting" Complete this sentence.

- a) inflation
- b) tax receipts
- c) employment
- d) budget deficits

12. "Supply-side economics, packaged and popularized as 'Reaganomics,' has become a big deal in the current policy debate over the fight against stagflation. To counteract this phenomenon of persistent high inflation, unemployment and stagnant growth, supply-side policies emphasize increasing production to take the pressure off prices." How would this policy be reflected on an AS/AD diagram?

- a) the AS curve shifts up
- b) the AD curve shifts right
- c) the AS curve shifts down
- d) the AD curve shifts left

13. "With the economy mired in recession, it is almost a classic case of room for government stimulus without damage." This means that the government can increase spending with no resulting increase in

- a) income
- b) inflation
- c) tax receipts
- d) unemployment

14. Since the long-run aggregate supply curve is vertical, then, in the long run,

- a) real national income and the price level are determined by aggregate demand
- b) real national income and the price level are determined by aggregate supply
- c) real national income is determined by aggregate supply and the price level by aggregate demand
- d) real national income is determined by aggregate demand and the price level by aggregate supply

15. If the demand-side effects of a supply-side tax cut dominate the supply-side effects, then we can expect the tax cut to

- a) decrease output and the price level
- b) increase output and the price level
- c) decrease output and increase the price level
- d) increase output and decrease the price level

16. According to supply siders, the most pronounced effect of a supply-side tax cut is a

- a) leftward shift of the aggregate supply curve
- b) leftward shift of the aggregate demand curve
- c) rightward shift of the aggregate supply curve
- d) rightward shift of the aggregate demand curve

17. An increase in the overall price level that is accompanied by a short-run increase in unemployment is most likely to be caused by

- a) a decrease in aggregate demand
- b) a decrease in aggregate supply
- c) an increase in aggregate demand
- d) an increase in aggregate supply

18. If we are at the natural rate of unemployment, an increase in aggregate demand will lower unemployment in the short run
- a) regardless of workers' price rise estimate
 - b) if workers overestimate the consequent price rise
 - c) if workers underestimate the consequent price rise
 - d) if workers perfectly anticipate the consequent price rise
19. Which of the following would not be considered a supply-side tax cut?
- a) a \$100 per person tax reduction
 - b) reduced tax rates on interest income
 - c) faster capital depreciation allowances
 - d) reduction in the rate of tax on capital gains
20. The economy's self-correcting mechanisms
- a) are non-existent
 - b) correct inflationary gaps more easily than recessionary gaps
 - c) correct recessionary gaps more easily than inflationary gaps
 - d) work equally well/poorly for both gaps
21. If the aggregate supply curve is relatively flat, but not completely flat,
- a) "the" multiplier when expressed in real terms should be a bigger number than when expressed in nominal terms;
 - b) "the" multiplier when expressed in real terms should be a smaller number than when expressed in nominal terms;
 - c) "the" multiplier when expressed in real terms should be exactly the same number as when it is expressed in nominal terms
 - d) there is not enough information given to determine the relative sizes of the real and nominal multipliers
22. If the economy experiences a negative supply-side shock and the government counters with a stimulating fiscal policy, the only result we can be sure of is
- a) a lower price level
 - b) a higher price level
 - c) a lower level of output
 - d) a higher level of output
23. An important ingredient in the debate over supply-side economics is that
- a) the cost of supplying goods and services is rising
 - b) programs that increase production often increase economic inequality
 - c) economic theory can give no guidance to policy-makers about the effects of an untried policy
 - d) the gap between "winners" and "losers" must be narrowed if society is to provide incentives for success
24. The aggregate supply curve will shift up for all the following except
- a) an increase in wage rates
 - b) a decrease in productivity
 - c) an increase in the price level
 - d) an increase in the price of raw materials
25. A period of rising prices along with rising unemployment is the normal aftermath of a period of
- a) excessive aggregate supply
 - b) deficient aggregate demand
 - c) excessive aggregate demand
 - d) a rapidly rightward-shifting aggregate supply curve

26. An economist claims that a government fiscal policy to increase income by \$2b will not create much upward pressure on prices. He/she must believe that the

- a) aggregate supply curve is flat
- b) aggregate demand curve is flat
- c) aggregate supply curve is steep
- d) aggregate demand curve is steep

27. The Laffer curve

- a) shows how the tax rate affects GDP
- b) shows how the tax rate affects tax receipts
- c) shows how the tax rate affects the budget deficit
- d) shows how the tax rate affects incentives to spend

28. When comparing an increase in government spending on goods and services to an increase in private investment spending, in the short run

- a) they will both shift aggregate supply
- b) they will both shift aggregate demand
- c) government spending is inflationary; private investment is not
- d) government spending must equal taxes; private investment must equal saving

29. "The net effect of the proposed Clinton taxes would be to raise the marginal tax rate of typical employees by more than 15 percentage points. The White House appears unaware that taxes do more than transfer money from individuals to the government. High marginal tax rates also distort _____ " The blank is best filled with

- a) policy rules
- b) the meaning of a budget deficit
- c) incentives to work, save and invest
- d) the operation of the money multiplier

30. "The share of taxes paid by the top one-half percent of income-earners rose to 18% in 1984-85 from 14% in 1981, despite (or rather because of) the reduction in the top marginal tax rate." This most likely happened because

- a) the budget deficit fell
- b) the economy grew dramatically
- c) top income earners avoided less tax
- d) more people moved into the top one-half percent

31. "Business organizations are more optimistic, saying the job market is so tight employers will not part with workers for fear " This statement is best completed with

- a) of inflation
- b) of rising wages
- c) they will lose experienced employees
- d) of unemployment

32. "Economists said that even after taking hurricane and strike distortions into account, industrial production data signaled that manufacturers were bracing for tougher conditions." What name would economists give to "hurricane and strike distortions?"

- a) a fall in aggregate demand
- b) a supply-side shock
- c) a failure of the price system
- d) a tax hike equivalent

33. "Indeed, the study finds that it is quite likely that the lower rates have generated significant Laffer curve effects – meaning the government" The best way to complete this statement is

- a) collects more revenue
- b) has lower borrowing costs
- c) moves towards a budget deficit
- d) can increase spending without fearing inflation

34. "The atmosphere is part of the economy too, the real economy that is, not the artificial construct portrayed in the GDP. It does real work, as we would discover quickly if it were to collapse. Yet the GDP does not include this work. If we burn more gas, the expenditure gets added to the GDP. But there is no corresponding subtraction for the toll this burning takes on the thermostatic and buffering functions that the atmosphere provides. Nor is there a subtraction for the oil we take out of the ground."

What is the main point being made here?

- a) the real multiplier is smaller than we think
- b) GDP measurement is misleading
- c) "crowding out" is more important than is believed
- d) more attention should be paid to the supply side of the economy

Answers: 1b 2b 3c 4c 5d 6c 7c 8d 9a 10a 11b 12c 13b 14c 15b 16c 17b 18c 19a 20b 21b 22b 23b 24c 25c 26a 27b 28b 29c 30c 31c 32b 33a 34b

Chapter 7: Growth

1. "Economist McKenzie attacks both American political parties' attraction to what he calls 'jobilism' - trying to create jobs mostly by protecting current jobs, thence reducing churn." Protecting current jobs is

- a) good because it avoids inflation
- b) good because it promotes efficiency
- c) bad because it creates unemployment
- d) bad because it inhibits productivity growth

2. "Lipsey points to evidence that when demand is held too long below capacity output, capacity itself may shrink, at least relative to the potential labor force." Capacity would shrink because of low levels of

- a) investment
- b) consumption
- c) unemployment
- d) government spending

3. "It seems that Americans prefer to cut down on their saving to maintain living standards; the catch is that a low saving rate makes it harder to increase living standards." Low saving makes it harder to increase living standards because it causes

- a) high taxes
- b) low investment
- c) low consumption
- d) low government spending

4. "He believes that the nation's core economic problem remains slow growth in productivity - a condition that is worsened, if not caused, by Americans' historically low rate of" Complete this sentence.

- a) saving
- b) unemployment
- c) consumer spending
- d) government spending

"On those rare occasions when the economic benefits of accelerated infrastructure spending are discussed, it is usually in the context of the countercyclical role assigned to such spending by John Maynard Keynes, leading to charges of make-work projects with little economic value. Precious little is said about the critical links that exist between quality infrastructure and" "

5. Countercyclical government spending is

- a) offset by appropriate tax policy
- b) higher in booms and lower in recessions
- c) lower in booms and higher in recessions
- d) steady during all parts of the business cycle

6. Complete this clipping.

- a) taxation
- b) inflation
- c) unemployment
- d) aggregate supply

7. "Given the low level of savings and investment, some economists now fear that the United States will be lucky during the 1990s to match the record of the 1980s when the amount of goods and services produced by each worker rose a scant 0.8 percent a year." What technical term do economists use to talk about the phenomenon being discussed here?

- a) inflation
- b) productivity
- c) unemployment
- d) national saving

8. "Over the longer term business may be shooting itself in the foot by taking a hard line against government taxing and spending policies if this hard line causes a decline in public spending on the economy's infrastructure - roads, sewers, bridges, and other public works." The essence of this argument is that a decline in infrastructure leads to

- a) higher taxation
- b) lower inflation
- c) lower productivity
- d) lower national saving

9. "The case for tax breaks for investment rests on the claim that because of big spillover effects, the return on investment in machinery and equipment to the economy as a whole is far greater than" Complete this clipping.

- a) the inflation created by this policy
- b) the return to consumers from saving
- c) the return to the businesses doing the investing
- d) the incentives to avoid the tax

10. "A popular view is that the best way for governments to stimulate growth is to improve the functioning of markets and adopt stable and credible macroeconomic policies which encourage firms to take a long-term view. The trouble with this view is that governments, like voters, are more interested in" Complete this clipping.

- a) the short run
- b) inflation and unemployment
- c) smoothing the business cycle
- d) all of the above

11. "Countries with a high level of education tend to absorb new technology more quickly and therefore grow more quickly. But one problem is that firms and workers cannot capture the external benefits from investing in education, which means that they" Complete this clipping.

- a) cause higher unemployment
- b) invest too much in education
- c) do not invest enough in education
- d) demand unrealistic wages and prices

12. "Although the Americans talked boldly about boosting investment, they mainly ducked the question of how to boost America's low rate of _____. To finance higher investment America would have to increase _____ or slash _____." Fill in the blanks.

- a) saving; taxes; government spending b) saving; government spending; taxes
c) taxation; saving; government spending d) taxation; government spending; saving

13. "They don't seem to be getting the underlying message in the country's failures in domestic and international markets: America has been destroying too few jobs." By destroying too few jobs America has been

- a) creating inflation b) creating unemployment
c) inhibiting productivity increases d) wasting government tax revenues

14. "He claims that we must view the loss of hundreds of thousands of jobs in the U.S. textile industry over the past two decades as a positive measure of the success of the industry in dramatically improving" Complete this clipping.

- a) inflation b) import sales c) productivity d) unemployment

15. "Yet Mr. Stein himself estimates that the growth of budget deficits during the 1980s cut 3 percent from the decade's GDP." The logic of this is that the deficits

- a) caused crowding out which lowered GDP
b) caused higher taxation which lowered aggregate demand and so decreased GDP
c) diverted saving from investment and so caused a smaller productive capacity
d) diverted saving from consumption and so caused a smaller aggregate demand and thus a smaller GDP

16. "Domestic investment did not fall as sharply as did national saving because" Complete this clipping.

- a) private saving increased b) the government deficit shrank
c) businesses borrowed at higher cost d) businesses borrowed from foreigners

17. Suppose income is \$700b, consumption is \$500b, taxes are \$60b, and government spending is \$80b. National saving is

- a) \$100b or less b) more than \$100b but not more than \$130b
c) more than \$130b but not more than \$180b d) more than \$180b

18. Suppose national saving is \$150b, the government deficit is \$30b and gross investment is \$170b. Foreign financing is

- a) \$20b or less b) more than \$20b but not more than \$30b
c) more than \$30b but not more than \$50b d) more than \$50b

19. Suppose the multiplier is 3, the marginal tax rate is 20%, and the marginal propensity to consume out of disposable income is 0.9. If government spending increases by \$10b, then national saving

- a) increases b) decreases by \$1b or less
c) decreases by more than \$1b but not more than \$2b d) decreases by more than \$2b

20. Over the long run the most important determinant of our standard of living is

- a) judicious use of fiscal policy to prevent recessions
- b) increases in productivity due to technological change
- c) avoiding the unemployment caused by technological change
- d) keeping money supply growth approximately equal to the real rate of growth

21. In the long run, the rate of growth of real wages is approximately equal to the rate of

- a) inflation b) growth of labor productivity
- c) growth of labor productivity plus inflation
- d) growth of labor productivity minus inflation

22. An expansionary monetary policy and contractionary fiscal policy mix would increase future economic growth if it promoted

- a) low interest rates, which encourage business investment
- b) high interest rates, which encourage people to save and invest
- c) low levels of personal savings to finance present consumption
- d) high levels of personal savings to finance future consumption

23. The limit of an economy's total productive capacity at any given time is set by

- a) the amount of money in circulation b) business demand for goods and services
- c) the level of government spending and taxation
- d) the quantity and quality of its productive resources

24. National saving is

- a) the same as private saving b) private saving plus foreign financing
- c) private saving less the government deficit
- d) private saving plus foreign financing less the government deficit

25. "Some economists believe the economy is able to grow without _____ because of strong improvements in _____ brought about by huge investments in new technology by business." The blanks are best filled in with

- a) inflation; productivity b) inflation; aggregate demand
- c) unemployment; productivity d) unemployment; aggregate demand

26. "One of the professors' more controversial findings is that public investment in physical capital (as opposed to human capital) in the last forty years has had a negative effect on economic growth. The researchers speculate that this is because public investment has "crowded out"" This is best completed with

- a) imports b) exports c) consumption d) private investment

27. "The Opposition said that while it welcomed the high levels of growth, 'it is low-quality growth because investment is a missing ingredient. This is simply recovery brought about by government pump-priming. This growth cannot be sustained.' " A counterargument to this claim is that

- a) investment is not an important ingredient in sustained growth
- b) higher consumption spending, not investment spending, is the ultimate goal
- c) as the recovery pushes the economy to capacity investment will be forthcoming
- d) government pump-priming is an acknowledged means of stimulating an economy

28. "Jorgenson said that the high cost of imported energy will cause business in general to substitute labor for energy in the production process and that this would likely have a number of harmful effects on the economy: reduced growth, lower productivity and higher inflation." This phenomenon causes reduced productivity because

- a) it decreases the number of jobs
- b) labor has less energy to work with
- c) businesses no longer try to minimize costs
- d) businesses no longer try to adopt the most efficient production techniques

29. "The case for tax breaks for investment is based on the claim that, because of big spillover effects, the return on investment in machinery and equipment to the economy as a whole is" This is best completed with

- a) practically zero
- b) less than the current rate of interest
- c) less than the return to an individual firm
- d) greater than the return to an individual firm

30. "Since 1991 business-sector productivity has increased at a 1.3 percent annual rate, while the adult population has increased at a 1 percent annual rate. Meantime, business output has risen 3.3 percent per year. The 1-percentage-point gap between output growth and productivity-adjusted population growth has been filled by" This is best completed with

- a) increases in the capital stock
- b) increases in the unemployment rate
- c) decreases in hours worked per employee
- d) increases in the labor-force participation rate

31. "The fact that economic performance strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to _____ diminish as product prices become more stable." The blank is best filled with

- a) employ more people
- b) purchase consumer durables
- c) invest in productive capital
- d) undertake fiscal fine-tuning

32. "We should expect that after a couple of years of very robust gains in productivity (1.7% last year and 1.9% the year before, a substantial improvement on the 1% annual average over the 1974-95 period), productivity gains would be more moderate." We would expect more modest productivity gains because

- a) capacity constraints have been reached
- b) consumption demand should accelerate
- c) unemployment will likely be above the natural rate
- d) it takes time for investment to augment the capital stock

33. "A couple of years ago, economists would have considered such low unemployment a sure sign that prices were about to rise. Today they point to productivity as the reason why that might not happen." Productivity could avoid price rises by

- a) discouraging workers
- b) stimulating the demand for labor
- c) increasing the natural rate of unemployment
- d) allowing wage increases without requiring price increases to maintain profitability

34. "The Labor Department reported that output rose at a 3.9% annual rate, while hours worked were up 1.2%. The higher output, analysts said, was largely a result of businesses

working their employees longer rather than adding to payrolls." During the third quarter productivity rose at an annual rate of

- a) 2.7% if no new workers were hired
- b) 3.9% if no new workers were hired
- c) 2.7% regardless of how many new workers were hired
- d) slightly below 3.9% depending on how many new workers were hired

35. "Fed chairman Allan Greenspan worries that new Treasury borrowings could cause some crowding out and keep long rates _____ and economic growth _____ than normal." Fill in the blanks.

- a) high; higher
- b) high; lower
- c) low; higher
- d) low; lower

36. "One question is whether the government can steel itself to bring its fiscal policy into line with the central bank's monetary policy. Will the government be able to borrow the funds it will need to cover this year's deficit out of the existing money supply, which the Fed is trying to restrict?" If the government tries to borrow more funds than are available there will be a rise in

- a) exports
- b) inflation
- c) interest rates
- d) unemployment

37. "Fears had been expressed that financing of the federal deficit might squeeze private borrowers out of the market." Private borrowers are squeezed out of the market by

- a) inflation
- b) higher taxes
- c) federal regulations
- d) higher interest rates

38. "Economists at the seminar agreed that the U.S. deficit of about \$180 billion is severely straining domestic capital markets because private-sector capital demand is proving to be exceptionally buoyant." 'Severely straining' means producing

- a) inflation
- b) higher taxes
- c) unemployment
- d) higher interest rates

39. "In a closed economy, government borrowing "crowds out" household and business investment by pricing them out of available savings, i.e., by _____. So fiscal stimulus has no net impact on the economy. But in an open economy, excess demand for capital is met from" Fill in the blank and complete this clipping.

- a) higher taxes: higher exports
- b) higher taxes; foreign financing
- c) higher interest rates: higher exports
- d) higher interest rates; foreign financing

40. "In general, the Treasury is doing less to "crowd out" private debtors, a phenomenon long considered to be one of the economy's weak points. Savings that would previously have gone into sterile government paper is instead available to"

This is best completed with

- a) pay higher taxes
- b) finance exports
- c) finance private investment
- d) increase consumption spending

41. "Another criticism of deficit budgets is that they hamper the private sector's ability to raise capital." This hampering is caused by

- a) high taxes
- b) high bond prices
- c) high interest rates
- d) central bank bond purchases

42. "Ordinarily, an increase in the budget deficit raises interest rates, but this does not always happen." This may not happen because

- a) the deficit may have been caused by a recession

- b) the deficit may have been caused by a tax rate decrease
- c) the deficit may have been caused by a government spending increase
- d) the deficit may have been financed by buying rather than selling bonds

43. "U.S. Federal Reserve Board chairman Paul Volcker told senators Thursday the huge federal budget deficit is causing disturbing pressures on interest rates." This is disturbing because

- a) interest rates are being pushed too low, creating inflation
- b) interest rates are being pushed too low, lowering saving
- c) interest rates are being pushed too high, creating inflation
- d) interest rates are being pushed too high, crowding out private investment

44. "The debt buildup is worrisome because it is not financing" Complete this sentence.

- a) budget deficits
- b) bond purchases
- c) capital investment
- d) consumption spending

45. "For future generations, much more important than the size of the deficit is whether government resources are being used to" Complete this clipping.

- a) battle inflation
- b) build infrastructure
- c) reduce interest rates
- d) battle unemployment

46. "Budget deficits are sometimes useful to spur consumption and thus encourage investment in business plant and equipment, but more generally they discourage rather than encourage investment because they" This clipping is best completed with

- a) create inflation
- b) raise interest rates
- c) lower interest rates
- d) decrease aggregate demand

47. High savings rates have been a hallmark of Asia's economic development, helping the region's economies _____. Now they have come to be seen as a handicap because _____." The best way to fill these blanks is

- a) finance investment; the fall in aggregate demand worsens the recession
- b) finance investment; this creates inflation
- c) avoid inflation; the fall in aggregate demand worsens the recession
- d) avoid inflation; this creates inflation

48. "One theory as to why productivity in Canada and Europe does not adjust to recessions as robustly as the United States is that the U.S. market is inherently more flexible. Its labor laws and work force practices" This statement is best completed with

- a) protect workers from being laid off
- b) allow workers to be laid off easily
- c) fix wages for workers
- d) force workers to belong to unions

49. "As profits increase, there's going to be a need for a capital rationing process." The capital rationing process in the U.S. economy operates through

- a) interest rates
- b) government spending
- c) taxes
- d) unemployment changes

50. "The survey of global labour market trends from the Geneva-based International Labour Organisation (ILO) found that Americans worked longer hours than Europeans, clocking up an average of 1,825 hours last year, compared with 1,300-1,800 hours in leading European economies. While unemployment in the EU as a whole was higher than in the US, one key indicator, the employment-to-population ratio, rose from 56.1 to 56.7 per cent between 1999 and 2002. The same measure fell from 64.3 to 62.7 per cent in the US during the same period." From these numbers it is likely that per capita income in the U.S. is

- a) higher than in Europe and the participation rate is lower
- b) higher than in Europe and the participation rate is higher
- c) lower than in Europe and the participation rate is lower
- d) lower than in Europe and the participation rate is higher

51. "India, however, is strong in ways that are not always apparent. Although its savings rate is lower than China's, it uses investment more efficiently to produce economic growth." "Uses investment more efficiently" means that investment projects are chosen by

- a) the government
- b) the capital market
- c) the central bank
- d) foreigners

52. "A key economic adviser to President George W. Bush said yesterday he believed that national saving was too low in the US. But he agreed that encouraging consumers to save at a time when their spending was largely responsible for keeping the US economic recovery on track could be risky. But in the longer term, he said, the rationale for increasing savings in the US was clear." The logic behind this statement is that in the short run higher saving

- a) decreases demand and so increases unemployment, but in the long term it increases the capital stock
- b) increases demand and so decreases unemployment, but in the long term it increases the capital stock
- c) decreases demand and so increases unemployment, but in the long term it decreases the capital stock
- d) increases demand and so decreases unemployment, but in the long term it increases the capital stock

53. "One way corporations justify growing debt is that it enables the expansion of markets and capital assets. But that isn't the case with the federal government. It produces nothing. Money tied up in the debt may go partially for necessities or entitlements that large segments of the population want to continue, but the debt itself is not an example of productive debt." What is an example of government "productive debt"? Borrowing to

- a) feed the poor
- b) subsidize medical care
- c) build roads
- d) pay pensions

54. “Identifying bubbles is a thorny problem. Sharp price rises that appear irrational might in fact turn out to be justified. Policy makers need to be careful of trusting their judgment over the collective judgment of the market because efforts to restrain prices could interfere with the crucial role markets play in” The best way to complete this statement is

- a) determining unemployment
- b) balancing the budget
- c) controlling inflation
- d) allocating capital

55. “Three quarters of all Americans worked on farms in 1800. Only 40 per cent did in 1900. And in 2000 only 3 per cent. This change was the best thing that could have happened to Americans.” Explain why this change was so desirable.

- a) the unemployment rate fell dramatically
- b) inflation was prevented
- c) the business cycle disappeared
- d) creative destruction operated

56. “The argument is simple and convincing: Driven by an inexorable urge to cut costs and boost profits, business buys the latest labor-saving technology and fires workers, leading to higher unemployment across the economy. The government needs to do something about this greedy behavior.” Evaluate this argument.

- a) good argument because unemployment is bad
- b) good argument because market failures need government fixups
- c) bad argument because government is just as greedy
- d) bad argument because it would inhibit growth in the standard of living

57. “Australia has passed the fruits of economic growth to working people through tax cuts, which encourages growth because” This clip is best completed with

- a) of supply side effects
- b) aggregate demand is increased
- c) the multiplier operates
- d) unemployment falls

58. “Inequalities often lead to calls for government intervention to redistribute wealth. But history has shown the result is often not only less inequality, but also less” This clip is best completed with

- a) overall standard of living
- b) unemployment
- c) inflation
- d) taxes

59. “Every time you say that you want to “stimulate” the economy, or get it going again, or whatever words you use, what you are actually doing is urging more expenditure without regard to what that expenditure is and what it might accomplish, and without regard to what it might crowd out or displace in the process.” What is the main point being made here?

- a) the multiplier is smaller than we think
- b) “crowding out” is bigger than is believed
- c) more attention should be paid to the long-run supply side of the economy

- d) more attention should be paid to the impact of expenditure increases on unemployment

60. "Economic policy these days is very risky because of a basic contradiction between near-term efforts to mitigate the recession and the long-term goal of growth." This contradiction is that

- a) taxes need to be increased for short term but increased for long term
- b) saving needs fall for short term but increase for long term
- c) interest rates need to fall for short term but increase for long term
- d) government spending needs to rise for short term but fall for long term

61. "A rapid, global, private sector shift to thrift is exactly what the world economy does not need, but it ought to be good news in the long term." The logic here is that higher thrift

- a) decreases current aggregate demand, but by financing investment increases long term growth
- b) finances current deficit spending, but reduces the deficit in the long run
- c) means higher taxes which decreases current aggregate demand, but finances long term government spending
- d) decreases aggregate demand, but stimulates the economy through supply-side effects

Answers: 1d 2a 3b 4a 5c 6d 7b 8c 9c 10d 11c 12a 13c 14c 15c 16d 17b 18a 19c 20b 21b 22a 23d 24c 25a 26d 27c 28b 29d 30d 31c 32a 33d 34c 35b 36c 37d 38d 39d 40c 41c 42a 43d 44c 45b 46b 47a 48b 49a 50b 51b 52a 53c 54d 55d 56d 57a 58a 59c 60b 61a

Chapter 8: The Money Supply

"M1 can be a slippery commodity. The central bank admits to having significantly underestimated the transactions money flying around the system. One reason is that banks' bigger corporate customers cottoned onto the advantage of so managing their moneys as to achieve, at a consolidated, central checking account, practically zero balances. For the banks promoting this switch of idle money to easily accessible interest-bearing deposits, there were similar economies: reserve requirements on such deposits are much lower."

1. "Transactions" money is money used as a
 - a) store of value
 - b) unit of account
 - c) medium of exchange
 - d) standard of deferred payment

2. What is the significance of underestimating transactions money?
 - a) monetary policy will be overstimulating the economy
 - b) monetary policy will be putting a drag on the economy
 - c) there is a need for money that the central bank should be meeting
 - d) the economy has too much money and therefore not enough spending

3. Why would corporations want to achieve zero balances in their checking accounts?

- a) to earn more interest
- b) to avoid paying taxes
- c) to keep a low profile
- d) to circumvent banking regulations

4. How do the banks gain from this corporate behavior?

- a) more loans can be made
- b) tax-free profits can be made
- c) interest rates can be increased
- d) by circumventing banking regulations

"In the process, the money multiplies, since the banks are allowed to lend more money than they actually have, within limits set by the Federal Reserve Board. The board tries to anticipate how much the money will multiply as this process unfolds. If its calculations are right, just enough money will be created to accommodate the growth it desires for the economy. If the calculations are wrong, it would make them right by pumping some money into the economy or pumping some out."

5. What money is being multiplied here?

- a) the money you and I hold as cash
- b) the money the government receives in taxes
- c) the money obtained by the Fed when it sold bonds
- d) the money spent by the Fed when it bought bonds

6. The "limits set by the Board" refers to

- a) the Fed's legal reserve requirement
- b) the amount of bonds bought by the Fed
- c) the amount of bonds sold by the Fed
- d) the amount of cash created by the Fed

7. What technical terminology do economists use to refer to "how much the money will multiply as this process unfolds"?

- a) the multiplier
- b) the money multiplier
- c) required reserve ratio
- d) open market operations

8. The board pumps money out of the economy by

- a) buying bonds
- b) selling bonds
- c) creating cash
- d) lowering the reserve requirements

"The deficit will mainly be financed by selling bonds to the general public and not to the central bank."

9. What happens to the money supply if the deficit is financed by selling bonds to the general public?

- a) the money supply increases
- b) the money supply decreases
- c) the money supply is unaffected
- d) we cannot tell what will happen to the money supply

10. What happens to the money supply if the deficit is financed by selling bonds to the central bank?

- a) the money supply increases
- b) the money supply decreases
- c) the money supply is unaffected
- d) we cannot tell what will happen to the money supply

11. "The Fed can "pay" for its bond purchases simply by crediting the amount of its purchases to the account of the bank involved in the transaction. As a result," Complete this clipping.

- a) bank reserves ultimately increase by this amount times the money multiplier
- b) bank reserves ultimately decrease by this amount times the money multiplier
- c) the money supply ultimately increases by this amount times the money multiplier
- d) the money supply ultimately decreases by this amount times the money multiplier

12. "The annual growth rate in what had once been the officially-watched aggregate, M1, was 4 percent last year, but for M2, the rate was 12 percent." Why might M2 be growing so much faster than M1?

- a) the central bank was increasing M2 reserves faster than M1 reserves
- b) the central bank was increasing M1 reserves faster than M2 reserves
- c) people were holding their money wealth mainly in term deposits rather than checking accounts
- d) people were holding their money wealth mainly in checking accounts rather than term deposits

13. "Money deposited for a term is not left in bank vaults but is loaned out by the banks (subject to minimum cash reserve requirements). This means that a dollar on deposit can flow back into the banking system one or more times and that dollar can expand the money supply." What terminology do economists use to refer to the process described in this clip?

- a) the multiplier
- b) the money multiplier
- c) required reserve ratio
- d) open market operations

14. "The impact on this monetary aggregate of extensive financial innovation - the changes in the kinds of deposits and services offered by banks - led the central bank to drop M1 as an intermediate target. With the changes in the way the public was holding payments balances, the M1 aggregate no longer had the same reliable link to" Complete this clipping.

- a) tax rates
- b) the money supply
- c) aggregate demand
- d) government spending

15. "Although he didn't say so, this may ultimately compel the central bank to resort increasingly to managing the money supply by managing banks' excess cash reserves - the stuff from which the banks create loans." How would the central bank manage these excess reserves?

- a) by buying bonds
- b) by selling bonds
- c) by changing reserve requirements
- d) all of the above

16. "If I ask a worker to get me a spare part for my car, he'll refuse to do it for money, but will do it for vodka." This phenomenon is happening in Russia because of a very high

- a) tax rate
- b) inflation rate
- c) alcoholism rate
- d) unemployment rate

17. "Monetizing the debt means that the Federal Reserve is not seeking buyers for all the government bonds, but is _____. This, essentially, means that the Federal Reserve is" Fill in the blank and complete this clipping.

- a) buying them itself; printing money
- b) buying them itself; shrinking the money supply
- c) selling them to the commercial banks; printing money
- d) selling them to the commercial banks; shrinking the money supply

Suppose that the central bank buys \$4 billion of bonds on the open market and the banks wish to hold reserves of 8 percent.

18. What is the largest amount the money supply could ultimately increase?
 a) \$4b b) \$32b c) \$50b d) \$80b
19. What would the money multiplier be in this case?
 a) 4 or less b) more than 4 but not more than 8
 c) more than 8 but not more than 12 d) more than 12
20. If when extra deposits are created customers increase their holdings of cash by 3 percent of those extra deposits, the money multiplier
 a) is unaffected b) becomes larger
 c) becomes smaller d) can't tell what should happen
21. Suppose the money multiplier is 6. What happens to the money supply if the Fed buys \$3 billion of bonds?
 a) \$3b increase b) \$3b decrease c) \$18b increase d) \$18b decrease
22. Suppose you sell a bond to the Fed for \$10,000 and deposit the proceeds in your checking account. As a direct result of this
 a) M1 and M2 both increase b) M1 increases and M2 decreases
 c) M1 increases and M2 is unchanged d) M1 is unchanged and M2 increases
23. Suppose you buy a \$500 term deposit by writing a check on your checking account. As a direct result of this
 a) M1 and M2 both increase b) M1 decreases and M2 increases
 c) M1 increases and M2 is unchanged d) M1 decreases and M2 remains unchanged
24. Money and income are
 a) mirror images of each other b) two quite different concepts
 c) both measured as a per annum flow d) two ways of looking at the same thing
25. You move some of your savings account balance into your checking account.
 a) M2 falls and M1 rises b) M1 falls and M2 rises
 c) M1 and M2 are unchanged d) M1 rises and M2 remains unchanged
26. The quantity of money demanded varies
 a) directly with both prices and output b) inversely with both prices and output
 c) directly with prices and inversely with output
 d) inversely with prices and directly with output
27. If the central bank prints more \$10 bills and spends them, then as a direct result of this action

- a) M1 and M2 both increase b) neither M1 nor M2 increase
c) M1 increases but M2 does not d) M2 increases but M1 does not

28. A sale of government bonds by the central bank should cause
a) bond prices to rise b) an increase in the supply of money
c) an increase in chartered banks loans
d) a decrease in reserves of the banking system

29. The money multiplier tells us the ultimate increase in
a) the income level due to an increase in the money base
b) the money supply due to an increase in the money base.
c) the money supply due to an increase in the income level
d) the income level due to an increase in the money supply

30. "The earlier predictions underestimated currency in circulation and treasury balances at the Fed, both of which drained reserves from the banking system." Lower reserves means
a) lower interest rates b) lower money supply
c) lower unemployment d) higher inflation

31. "A significant difference exists between the consequences of federal as opposed to state borrowing if the federal government borrows by selling bonds to the Federal Reserve. It alone can do so - the central bank buys only federal bonds." This significant difference is that state borrowing
a) reduces taxes b) reduces unemployment
c) doesn't have to be repaid d) cannot increase the money supply

"Economists call the process debt monetization. Without it, rising federal deficits tend merely to shuffle spending to the government sector from the private sector."

32. Debt monetization is financing deficits by
a) raising taxes b) raising the interest rate
c) selling bonds to the public d) selling bonds to the central bank

33. The fact that spending is merely shuffled to the government sector from the private sector means that
a) the multiplier is large b) there is complete crowding out
c) we must be at less than full employment
d) the deficits must cause a fall in the interest rate

34. "The Treasury plans to pay down \$1.85 billion on the public debt with the sale Monday of about \$13 billion in short-term bills." Maturing bills outstanding total
a) \$1.85b b) \$11.15b c) \$14.85b d) insufficient information to tell

35. "The Federal government is piling up larger deficits than estimated in February as the recession....." This clipping is best completed with
a) lowers tax receipts
b) is fought with higher government spending

- c) eases
- d) prompts the Fed to buy more Treasury bills

Answers: 1c 2a 3a 4a 5d 6a 7b 8b 9c 10a 11c 12c 13b 14c 15d 16b 17a 18c 19d 20c 21c
22a 23d 24b 25d 26a 27a 28d 29b 30b 31d 32d 33b 34c 35a

Chapter 9: The Monetarist Rule

1. "Far better for central bankers to get out of the fine tuning business. Instead they should try to keep" Complete this clipping.
 - a) taxes low b) budgets balanced.
 - c) money growth low d) government spending in check

2. "The Fed based its monetary policy in the 1980s on the assumption that velocity would continue its upward trend. Had they assumed a constant velocity, money growth would have been _____ and inflation would have been _____ than what we actually experienced." Fill in the blanks.
 - a) higher; higher b) higher; lower c) lower; higher d) lower; lower

3. "Several bond issues will raise \$400 million, with the central bank picking up at least \$200 million. The central bank can also be counted on to take down more of the bonds than the planned \$200 million it has announced if they seem to be selling badly." The \$200 million purchase will cause the money supply to
 - a) increase by \$200 million b) decrease by \$200 million
 - c) increase by \$200 million times the money multiplier
 - d) decrease by \$200 million times the money multiplier

4. "The central bank claims that 'there are no aggregate measures or indicators of the rate of monetary expansion that are sufficiently reliable at present to be used as targets for policy, or that are uniquely helpful in the task of explaining the impact of monetary policy'. Accordingly, judgment about financial and economic conditions - rather than following a monetary rule - will continue to be the guiding force behind monetary policy." What argument is being used to defend the decision not to adopt a monetary rule?
 - a) velocity is constant b) velocity is unpredictable
 - c) velocity is rising steadily d) velocity is falling steadily

5. "How can this be? How can the economy show just as much inflation with money growing only half as fast? After all, the growth of M1 has been cut to about six percent, which is close to the four percent that we were told five years ago would produce a stable price level." A stable price level would be produced by a money supply growth rate equal to the economy's
 - a) tax rate b) long-run inflation rate
 - c) long-run real growth rate d) long-run nominal growth rate

6. "The rapid expansion of M2 occurred as inflation rates were at historically high levels. Instead of saving, people spent and turned money over quickly in the banking system." What terminology do economists use to refer to "turning money over quickly in the banking system"?

- a) a high velocity
- b) a high multiplier
- c) a high money multiplier
- d) a high reserve requirement

7. "The central bank has got it right. Its job is to take the punch bowl away just as the party gets roaring. And if you have 6 percent real growth a quarter like we did last year, it's quite a party you've got going." Why is it necessary to remove this punch bowl?

- a) to prevent inflation
- b) to stimulate employment
- c) to finance government spending
- d) to match growth in the demand for money

8. "Of course, a large body of economists now believes that if the 1970s taught us anything it's that macroeconomic fine-tuning is more trouble than it's worth. In effect, the economy's steering gears are so loose that unless you hit a very sharp curve, fiddling with the wheel is just as likely to do harm as good." This is an argument for

- a) fiscal policy
- b) driver education
- c) constant money growth
- d) discretionary monetary policy

9. "Followers of Milton Friedman of the University of Chicago were convinced that business cycles could be smoothed away simply by requiring the Federal Reserve to". Complete this clipping.

- a) keep the money supply constant
- b) increase money supply growth in recessions and decrease it in booms
- c) increase money supply growth in booms and decrease it during recessions
- d) increase the money supply at the same rate during booms and recessions

10. "The introduction of daily interest saving accounts attracted a growing portion of funds away from checking accounts. The upshot was that a given amount of M1 supported a higher level of total spending, or in other words, its _____ increased." Fill in the blank.

- a) velocity
- b) money multiplier
- c) income multiplier
- d) reserve requirement

11. "The problem with monetarism is that its advocates have seen it as infallible over short periods of time and wish it to be rigid in its application over all periods of time." The advocates of monetarism wish it to be rigid in its application over all periods of time to

- a) weaken fiscal policy
- b) avoid monetary policy errors
- c) strengthen the impact of monetary policy
- d) ensure the independence of the central bank

12. "I really don't believe monetary policy is a very useful tool for fine-tuning the business cycle or fighting unemployment directly. I do believe that what monetary policy can do is control the inflation rate." Those who don't believe that monetary policy is a very useful tool for fine-tuning the business cycle believe that

- a) monetary authorities never make mistakes
- b) monetary policy has long and variable lags

- c) the central bank has tight control over the money supply
- d) monetary authorities have accurate information about the state of the economy

13. "But the experience of M1 still unnerves: innovations in the banking system, especially interest-bearing checking accounts which at that time were not counted in M1, allowed the public to shift money holdings into and out of different instruments in such a way as to make the relationship between M1 and total spending in the economy unstable." The unnerving experience with M1 was that M1 velocity was

- a) constant
- b) unstable
- c) increasing steadily
- d) decreasing steadily

14. "A monetary rule need not mean a single, bald number. If the central bank fears velocity shifts, rules could be adopted for adjusting the target in the face of a trend change in velocity." If velocity were trending upward, the target money growth rate would be adjusted

- a) upward
- b) downward
- c) to be zero
- d) to match inflation

15. "If the Fed's sole objective is going to be fighting inflation, it may as well be run by a computer, say critics of a proposal to change its mandate." According to the monetarists, to run the Fed's inflation-fighting policy the computer should be programmed to

- a) keep the money supply constant
- b) increase money supply growth in recessions and decrease it in booms
- c) increase money supply growth in booms and decrease it during recessions
- d) increase the money supply at the same rate during booms and recessions

16. "A growing number of economists view the Fed's new willingness to take on more of the nation's debt as inflationary in the long run." This inflation worry is because

- a) the government may tax less
- b) the debt may become excessive
- c) the government may spend more
- d) the money supply may increase excessively

17. "With financial deregulation changing the meaning of money, the Fed finally abandoned the monetarist prescription of targeting the money supply." The monetarist prescription was abandoned due to

- a) unstable velocity
- b) uncertain Fed control over the money supply
- c) unsatisfactory performance of the monetarist prescription
- d) all of the above

18. "It is very difficult for politicians to take action - especially unpleasant action - against a problem until the problem seems compelling. By that time, though, action tends to be tardy. The point of economic management is to stabilize the economy, but a political system that requires signs of instability before it can act makes the process self-defeating." In terms of classic debates over economic policy, what does this argument support?

- a) monetary as opposed to fiscal policy
- b) fiscal as opposed to monetary policy
- c) policy rules as opposed to discretionary policy
- d) discretionary policy as opposed to policy rules

19. "Inflationary policies can spur growth for a time, which is why politicians have often found them so tempting. This is the best argument for making central banks" Complete this clipping.

- a) deficit lower by \$5b or more b) deficit lower by less than \$5b
 c) deficit higher by \$5b or less d) deficit higher by \$5b or more

28. If "the" multiplier is 6, the income multiplier with respect to the money supply is 4, and the money multiplier is 5, then which of the following policies does not increase income by \$50 billion dollars?

- a) increase government spending by \$3 billion and the money supply by \$8 billion
 b) Fed sale of \$2 billion bonds and increase government spending by \$15 billion
 c) Fed purchase of \$1 billion bonds and increase government spending by \$5 billion.
 d) Fed purchase of \$16 billion bonds and decrease government spending by \$5 billion.

29. Suppose "the" multiplier is 4, the income multiplier with respect to the money supply is 2, the money multiplier is 6, and the government is obliged by an election promise to increase government spending by \$5 billion, but wants the level of income to grow by only \$8 billion to avoid inflation. What monetary policy is required to accomplish this?

- a) buy \$1b bonds b) sell \$1b bonds c) buy \$2b bonds d) sell \$2b bonds

30. If the income multiplier with respect to the money supply is 3, "the" multiplier is 4 and the money multiplier is 5, then when the central bank buys two billion dollars of bonds on the open market, the income level should ultimately increase by

- a) \$6b b) \$8b c) \$10b d) \$30

31. Suppose the income multiplier with respect to government spending is 3.5, the money multiplier is 4.5 and the income multiplier with respect to the money supply is 2.5. What change in the equilibrium level of income would result if government spending were reduced by \$1000 and at the same time the central bank purchased bonds worth \$2000?

- a) less than or equal to \$5000 b) between \$5000 and \$10,000
 c) between \$10,000 and \$20,000 d) more than \$20,000

32. Suppose "the" multiplier is 4, the income multiplier with respect to the money supply is 3, and the money multiplier is 5. If the government increases its spending by \$6b and the Fed sells \$2b of bonds, the income level will

- a) fall b) rise by less than or equal to \$15b
 c) rise by between \$15b and \$35b d) rise by \$35b or more.

33. If banks desire to hold reserves equal to 4% of their deposits, and velocity is 5, then the largest the money multiplier could be is

- a) 4 b) 5 c) 20 d) 25

Consider an economy in which the real level of income is 500b 1992 dollars, "the" multiplier is 4, the money multiplier is 5, the income multiplier with respect to the money supply is 3, the price index is 120 (base year 1992), the current money supply is \$200b, inflation is 5%, and velocity is constant.

34. Velocity is

- a) less than 2.5 b) 2.5 c) 3.0 d) greater than 3.0

35. Ignoring inflation, the change in nominal income resulting from a central bank purchase of \$3b bonds is

- a) less than \$10b b) between \$10b and \$25b
c) between \$25b and \$50b d) over \$50b

36. Next year, the price index should be

- a) 120 b) between 120 and 125 c) 125 d) greater than 125

37. If in 1986 nominal GDP was about \$500 billion., then the stock of money (M1) was

- a) much more than this b) much less than this
c) about the same as this d) unrelated to this figure

Suppose the aggregate supply curve is vertical, velocity is 4, and the money supply increases by 10%. According to the quantity theory of money,

38. The percentage change in real income is

- a) 0% b) 10% c) 40% d) 2.5%

39. The percentage change in nominal income is

- a) 0% b) 10% c) 40% d) 2.5%

40. The percentage change in the price level is

- a) 0% b) 10% c) 40% d) 2.5%

41. If "the" multiplier is 6, the income multiplier with respect to the money supply is 4, and the money multiplier is 5, then to increase income by \$50 billion dollars the policy authorities could

- a) increase the money supply by \$2.5 billion
b) increase government spending by \$10 billion
c) increase both government spending and the money supply by \$4 billion
d) increase government spending by \$3 billion and the money supply by \$8 billion

42. Suppose the economy is at full employment with a real rate of growth of 3%. If innovations in the banking system are reducing, ceteris paribus, the need for money at 1% per year, what rate of growth of the money supply would you recommend to achieve a long-run inflation rate of 4%?

- a) 6% b) 7% c) 8% d) 9%

43. If rapid inflation occurs in a relatively full employment economy, well-coordinated monetary and fiscal policies would involve

- a) a budget deficit and central bank sales of bonds
b) a budget surplus and central bank sales of bonds,
c) a budget deficit and central bank purchases of bonds
d) a budget surplus and central bank purchases of bonds

44. In the past 40 years, there has been a generally consistent upward trend in velocity. According to the quantity theory of money, this implies

- a) real GDP has risen less (%) than the money supply during this period

- b) real GDP has risen more (%) than the money supply during this period
- c) nominal GDP has risen less (%) than the money supply during this period
- d) nominal GDP has risen more (%) than the money supply during this period

45. If you believe that velocity is constant and the AS curve is vertical, then according to the quantity theory of money, doubling the money supply should result in doubling of

- a) nominal and real output
- b) the price level and real output
- c) the price level with no change in real output
- d) real output with no change in nominal output

46. According to the modern quantity theory of money an increase in the money supply will result in an increase in the nominal level of income until

- a) velocity is unchanged
- b) the interest rate returns to its original level
- c) the demand for money rises by exactly the increase in the money supply
- d) the price level increases by the same percentage as the money supply has increased

47. The central bank and the government are working against each other if, as the government cuts taxes the central bank

- a) sells government bonds
- b) lowers the discount rate
- c) increases the money supply
- d) decreases the legal reserve requirements

48. A major advantage of monetary over fiscal policy is that monetary policy

- a) can be put into effect more quickly
- b) affects all sectors of the economy equally
- c) authorities are quicker to see the need for policy
- d) has a more direct and predictable impact on spending

49. Knowledge of the money supply can lead to good predictions of nominal GDP only

- a) if the price level is stable
- b) if the money supply is stable
- c) over very short periods of time
- d) if the determinants of velocity are known

50. The aggregate demand curve is downward sloping because a higher price level

- a) makes people wealthier and so they spend more
- b) causes higher wages and so people spend more
- c) cuts the real value of income and so people spend less
- d) decreases the real supply of money, decreasing spending

51. Believers in the monetarist rule assert that

- a) lags are long and variable
- b) the economy can be stabilized by automatic mechanisms
- c) the central bank should keep the money supply growth constant
- d) all of the above

52. Suppose you are a monetarist and believe in the monetarist rule, which the monetary authorities appear to be following. If the economy begins to experience a slight increase in its inflation rate you would recommend that the monetary authorities

- a) increase the money growth rate slightly
- b) decrease the money growth rate slightly
- c) leave the money supply growth unchanged
- d) enact a one-time slight decrease in the money supply

53. The essence of the monetarist policy rule is to

- a) fix the rate of growth of the money supply
- b) use monetary policy to fix the interest rate
- c) keep money supply growth equal to money demand growth
- d) use a robot to automatically raise money growth in recessions and lower it in booms.

54. During an inflation velocity is

- a) higher because people hold fewer real money balances
- b) lower because people hold fewer real money balances
- c) higher because people hold more real money balances
- d) lower because people hold more real money balances

55. Suppose velocity is constant and the real income elasticity of the demand for money (the percent rise in the demand for money due to a one percent rise in real income) is less than one. Then estimating inflation as money growth rate minus real growth rate

- a) overestimates inflation
- b) underestimates inflation
- c) is an erratic estimate of inflation
- d) remains an accurate estimate of inflation

56. If firms paying employees monthly began paying them weekly, then the demand for money would

- a) rise and income would rise
- b) rise and income would fall
- c) fall and income would rise
- d) fall and income would fall

57. The quantity of money demanded varies

- a) directly with both prices and output
- b) inversely with both prices and output
- c) directly with prices and inversely with output
- d) inversely with prices and directly with output

58. "Jobs increased at a healthy pace last month, the unemployment rate fell and the manufacturing sector stayed strong. As a result, most analysts think that when the Fed meets later this month it will _____ short-term interest rates in an effort to _____ economic growth and avoid _____." The blanks are best filled with

- a) lower; spur; layoffs
- b) raise; slow; inflation
- c) lower; spur; inflation
- d) raise; slow; layoffs

59. "The Fed has been criticized for raising interest rates before seeing any evidence of worsening inflation, but Fed chairman Alan Greenspan replied that "To successfully navigate a bend in the river, the barge must begin the turn well before the bend is reached," introducing a new monetary-policy metaphor." This policy action is

- a) contractionary, reflecting policy rules
- b) contractionary, reflecting policy discretion
- c) expansionary, reflecting policy rules
- d) expansionary, reflecting policy discretion

60. "A small but vocal clique of Japanese politicians has floated the idea that the Bank of Japan might purchase government bonds directly from the Ministry of Finance as a way to fund the government's rapidly expanding deficit. The plan, which would essentially have the central bank printing money to finance government spending, is opposed by the Bank of Japan." The Bank of Japan opposes this because it

- a) is an inflationary policy
- b) does not want to take responsibility for fiscal policy
- c) is an excessively expensive way to finance the deficit

d) would prefer to focus monetary policy on fixing the interest rate

61. "The chairman of the Federal Reserve Board stated that 'I remain concerned that economic growth will run into constraints if job growth continues. If some slowdown doesn't bring labor demand into line with its sustainable supply, _____ is a real danger and _____ economic policy may be necessary.'" The blanks are best filled with

- a) inflation; tighter b) inflation; easier
c) unemployment; tighter d) unemployment; easier

62. "Rising productivity does not in itself spell the end of inflation. With enough _____ it would still be possible to whip prices into a froth." The blank is best filled with

- a) income growth b) unemployment c) money growth d) taxes

63. Suppose real growth is 2%, velocity is constant, the money supply is \$200 billion, and the money multiplier is 4. If the monetary authorities want to maintain an inflation of 5%, how many billions of dollars of bonds should the central bank buy this year?

- a) 2 or less b) more than 2 but not more than 3
c) more than 3 but not more than 4 d) more than 4

64. Suppose the money multiplier is 5, long-run real growth is 2%, the current money supply is \$200 billion and inflation is 8%. What level of seigniorage is the government currently enjoying?

- a) \$4b or less b) more than \$4b but not more than \$10b
c) more than \$10b but not more than \$16b d) more than \$16b

Consider an economy in which the current level of income is \$800b, "the" multiplier is 4, the money multiplier is 5, the income multiplier with respect to the money supply is 3, the real interest rate is 3%, the current budget deficit is \$30b, the long-run real rate of growth is 2%, the current money supply is \$200b, velocity is constant, and the nominal interest rate is 10%.

65. Inflation is

- a) less than 7% b) 7% c) 8% d) more than 8%

66. Money growth is

- a) less than 7% b) 7% c) 8% d) more than 8%

67. Seigniorage is

- a) less than or equal to \$5b b) between \$5b and \$10b
c) between \$10b and \$20b d) greater than or equal to \$20b

68. "If we can't borrow all of the funds we need to finance expenditures which we are going to make in any event, we should at least look at the advisability of the central bank itself financing some of those expenditures simply by creating the money." This suggestion is

- a) unadvisable, because it creates inflation b) advisable, because it means lower taxes
c) unadvisable, because it creates unemployment

d) advisable, because it minimizes interest costs

69. "It is the rare consumer or investor who would not conclude that where government debt was growing faster than GDP, tax increases and/or accelerated inflation could not be far off." Accelerated inflation is an alternative to taxation in this context because

- a) the government may pay off the debt by printing money
- b) if inflation is accelerated people will refuse to pay taxes
- c) people may pass on higher taxes by increasing wages and prices
- d) people may fear a financial crisis and increase wages and prices accordingly

70. "There is no direct connection between the deficit and inflation. If there were, why did inflation hit 14 percent in 1948, a year when the government had a spending surplus? And why has inflation continued to fall the past two years while the deficit has been rising?" The strongest connection between the budget deficit and inflation is that

- a) inflation results indirectly if the deficit is financed by printing money
- b) inflation results directly from deficit spending creating excess demand
- c) inflation results indirectly from the higher interest rate caused by the deficit
- d) inflation increases nominal government spending which increases the deficit

71. Suppose the money multiplier is 4, the income multiplier with respect to the money supply is 5, nominal income growth is 8% and the money supply is \$400b. Seigniorage is

- a) \$8b
- b) \$32b
- c) \$6.4b
- d) none of the above

72. "The biggest criticism of central bankers is that their confidence in the link between the inflation rate and economic stability caused them to underestimate the dangers of asset bubbles." If a central bank believed in this link it would follow a policy of targeting on the

- a) interest rate
- b) real growth rate
- c) inflation rate
- d) money supply growth rate

73. "Most central bankers, including those at the Fed, don't allow monetary policy to be guided by a target for money supply growth. This is because" The best way to complete this statement is

- a) money growth is too difficult to measure
- b) velocity is unstable
- c) money growth is not fully under the control of the Fed
- d) all of the above

74. "Financial innovation and the spread of U.S. currency throughout the world have broken down relationships between money, inflation and growth, making monetary gauges" This statement is best completed with

- a) even more important for formulating monetary policy
- b) necessary for measuring the impact of monetary policy
- c) the most crucial ingredient for applying a monetary rule
- d) unreliable measures of the influence of monetary policy

75. "With the economy already running a negative output gap of 6%, a lack of money growth will likely only result in" This clipping is best completed with

- a) higher prices b) a larger negative output gap c) lower interest rates d) more taxes

“And this is also a good time to engage in some serious infrastructure spending, which the U.S. badly needs in any case. The usual argument against public works as economic stimulus is that by the time you get around to repairing the bridges” This clip was written in October of 2008, when the world was dealing with the big 2008 financial crisis. The next two questions relate to this clip.

76. This clip is best completed with

- a) you have run out of money
b) inflation has taken hold
c) the stimulus is no longer needed
d) the recession is even worse

77. In this context why would the usual argument not be convincing?

- a) we are clearly headed for a major, long-lasting recession
b) the Fed will clearly be increasing the money supply by huge amounts
c) the interest rate is bound to drop to make financing easy
d) inflation is not in the picture

78. “The empirical relationship between money growth and variables such as inflation and nominal output growth has continued to be unstable,” Mr. Bernanke said.” The implication of this for monetary policy is that

- a) a rule based on a monetary aggregate is no longer advisable
b) monetary policy is without strength
c) monetary policy should be abandoned in favor of fiscal policy
d) rules for monetary policy are not advisable

79. “A single cigarette now costs Z\$500,000. Mugabe blames hyperinflation on exploitative businessmen who are part of a Western plot to destabilize his country. His critics point instead to widespread economic mismanagement, corruption, and the government’s policy of” The best way to complete this statement is

- a) subsidizing food b) high interest rates c) printing money d) government deficits

80. “The Fed blames all problems on external influences beyond its control and takes credit for any and all favorable occurrences. It thereby continues to promote the myth that the private economy is unstable, while its behavior continues to document the reality that government is today the major source of economic instability.” What view of economic policy does this clip promote?

- a) a monetary rule
b) use fiscal policy, not monetary policy
c) the use of discretionary monetary policy
d) fix the interest rate

81. “While central bankers still accept that inflation is largely a result of money-supply growth, few target the money supply in practice because” The best way to complete this statement is

- a) money growth is too difficult to measure
- b) velocity is unstable
- c) money growth is not fully under the control of the Fed
- d) all of the above

82. "It took Paul Volker, who became Fed chairman in 1979, to put the monetarist theory into practice, adopting money-supply targets that drove interest rates to double-digit levels, sent the economy into a deep recession, and ultimately brought inflation down." What is this monetarist theory?

- a) inflation is always and everywhere a monetary phenomenon
- b) the main determinant of the inflation rate is the rate of growth of the money supply
- c) inflation can be controlled by controlling money growth
- d) all of the above

Answers: 1c 2a 3c 4b 5c 6a 7a 8c 9d 10a 11b 12b 13b 14b 15d 16d 17d 18c 19a 20a 21b 22c 23c 24c 25a 26b 27b 28d 29b 30d 31c 32a 33d 34c 35c 36d 37b 38a 39b 40b 41d 42a 43b 44d 45c 46c 47a 48a 49d 50d 51d 52c 53a 54a 55b 56c 57a 58b 59b 60a 61a 62c 63c 64a 65b 66d 67a 68a 69a 70a 71a 72c 73d 74d 75b 76c 77a 78a 79c 80a 81d 82d

Chapter 10: Monetary policy and Interest Rates

1. "Earlier in the week the central bank's traders intervened aggressively in the money market to push the yield on last week's Treasury bills sharply higher."

What kind of intervention is being referred to? The central bank

- a) sold bills
- b) bought bills
- c) announced an easier monetary policy
- d) raised the legal reserve requirement

2. "Several government bond issues will raise \$400 million, with the central bank picking up at least \$200 million. The central bank can also be counted on to take down more of the bonds than the planned \$200 million it has announced if they seem to be selling badly." This suggests that monetary policy is

- a) flexible
- b) inconsistent
- c) targeting on a fixed interest rate
- d) targeting on a fixed growth rate of the money supply

3. "Basically, investors profit in two ways from putting their money into bonds: through the coupon rate, or interest rate, that is attached to each bond and provides a steady income; and through" Complete this clipping.

- a) possible increases in bond prices
- b) capital gains if the interest rate rises
- c) avoiding the deleterious effects of unexpected inflation
- d) avoiding capital losses because the bond has a fixed face value

4. "The average yield at this week's auction of \$17.8 billion of 91-day treasury bills was 11.17 percent, up from 10.95 percent last week. The average bid price was \$97.290." Compared to last week, the average bid price

- c) monetary policy is targeting on a money growth rate
- d) traditionally money demand determines money supply

11. "Bonds rallied sharply yesterday, cheered on by the news that the recession isn't over yet. Prices climbed by as much as \$8.75 for each \$1,000 face amount in the U.S. government securities market after the Commerce Department reported that GDP fell by 0.1 percent in the second quarter." Bad news rallies bonds because it

- a) may cause the government to lower taxes
- b) may cause the Fed to decrease interest rates
- c) is usually accompanied by higher interest rates
- d) may cause the Fed to decrease the money supply

12. "The decline in both the number of payroll jobs and hours worked surprised many analysts, who said the report put new pressure on the Fed to" Complete this clipping.

- a) lower interest rates
- b) increase interest rates
- c) decrease the money supply
- d) keep money growth constant

13. "However, with the sharp fall in interest rates, central bank officials expect a pick-up in economic activity that will bring about a movement out of recession and an upsurge in monetary growth." The pick-up in economic activity will bring about an upsurge in monetary growth because

- a) a policy of fixed money growth requires this
- b) higher economic activity means higher money demand which determines money supply
- c) the pick-up in economic activity is because of a higher money supply - the clipping has it backwards
- d) the monetary authorities will match the higher money demand to prevent interest rate increases which could abort the movement out of recession

14. "The proper lines of action for controlling inflation are not too difficult to envisage. "First, we must stop relying on monetary policy to do the job. The monetary tool has been easiest and most convenient for all governments to use because it requires no legislation. It has been given a good trial. But it hasn't worked, and its economic impact has been discriminatory." Monetary policy is discriminatory because it has a relatively large impact on

- a) rural versus urban people
- b) southern people versus northern people
- c) the manufacturing versus service industry
- d) the residential versus non-residential construction industry

15. "The release of U.S. housing starts in April - down 17 percent to their lowest level in eight years - drove North American bond markets higher yesterday." This news increased bond prices because it puts pressure on the Fed to

- a) fight inflation
- b) raise interest rates
- c) lower interest rates
- d) keep money growth constant

"Thanks to a sharp cut in interest rates engineered by the Fed, many economists expect the economy to be growing again, albeit slowly, by spring, which is the soonest any of President Bush's legislative proposals are likely to be enacted."

16. What major advantage of monetary policy over fiscal policy does this clipping underline?

- a) monetary policy is more effective
- b) monetary policy is less discriminatory
- c) monetary policy can influence interest rates
- d) monetary policy can be undertaken more quickly

17. If this policy is so good, why isn't it done more vigorously, more often?

- a) because of the superiority of fiscal policy
- b) because of the danger of inflation creation
- c) because it suffers from diminishing marginal returns
- d) because politicians don't trust the Fed with this power

18. "According to Ibbotson Associates, 20-year government bonds are on track to post annual returns of 30 percent by the end of 1995. That would lag only the 40 percent returns of 1982 and the 31 percent returns of 1985." In 1995 the interest rate was far below 30 percent. How could 1995 returns on bonds be as high as 30 percent?

- a) the interest rate must have risen a lot
- b) the interest rate must have fallen a lot
- c) there was a large compensation for risk
- d) bond coupons were extraordinarily high

19. Suppose the current interest rate is 6 percent. What price should one expect to pay for a 3-month Treasury bill with face value \$10,000 that is one month old?

- a) \$9850 or less
- b) more than \$9850 but not more than \$9900
- c) more than \$9900 but not more than \$9950
- d) more than \$9950

20. A bond due to mature and pay \$1000 in one year's time has a coupon of \$65 and a current price of \$1015. The interest rate is

- a) less than 5%
- b) 5% or more, but less than 6.5%
- c) 6.5% or more, but less than 8%
- d) 8% or more

21. Suppose the interest rate is 7 percent, and a bond with an annual coupon of \$75 matures in one year's time, paying its face value of \$1000. This bond's current price is

- a) less than \$930
- b) \$930 or more, but less than \$970
- c) \$970 or more, but less than \$1000
- d) \$1000 or more

22. Consider a bond with a face value of \$1000, due to mature in one year's time. Its current price is \$1035, and the current interest rate is 5.8 percent. Its coupon is

- a) \$35 or less
- b) more than \$35 but less than \$55
- c) more than \$55 but less than \$75
- d) more than \$75

23. Suppose "the" multiplier is 3, the income multiplier with respect to the money supply is 4, the money multiplier is 5 and a Fed purchase of \$4 billion of bonds during a recession drops the interest rate by one percentage point. Suppose that to fight a recession monetary policy is undertaken to lower the interest rate by one-half a percentage point. The income level should increase by

- a) \$15b or less b) more than \$15b but not more than \$25b
c) more than \$25b but not more than \$35b d) more than \$35b

24. Suppose the impact on the interest rate of a \$3 increase in government spending can be eliminated by a \$2 increase in the money supply. If the income multiplier with respect to government spending is 4 and the income multiplier with respect to the money supply is 3, what mix of monetary and fiscal policy is required to increase income by \$9000 without changing the interest rate?

- a) increase government spending by \$900 and the money supply by \$1800
b) increase government spending by \$1200 and the money supply by \$800
c) increase government spending by \$1500 and the money supply by \$1000
d) increase government spending by \$3000 and the money supply by \$2000

25. A bond due to mature and pay \$1000 in one year's time has a coupon of \$85 and a current price of \$1025. The interest rate is about

- a) 5.85% b) 6.00% c) 8.29% d) 8.50%

26. Suppose the current interest rate is 5%. What price should one expect to pay for a \$1000 treasury bill, due to mature in one year, which had originally been sold when the interest rate was 10%?

- a) less than \$950 b) \$950 c) between \$950 and \$1000 d) more than \$1000

27. Consider a bond with a coupon of \$90, and a face value of \$1,000, due to mature in one year's time. The current interest rate is 10%. The current price of this bond is

- a) less than \$990 b) \$990 c) between \$990 and \$1000 d) more than \$1000

28. Consider a bond with a coupon of \$90, and a face value of \$1,000, due to mature in one year's time. The current interest rate is 5%. The current price of this bond is

- a) less than \$990 b) \$990 c) between \$990 and \$1000 d) more than \$1000

29. Consider a bond with a coupon of \$80, and a face value of \$1,000, due to mature in one year's time. The current interest rate is 10%. The current price of this bond is

- a) less than \$990 b) \$990 c) between \$990 and \$1000 d) more than \$1000

30. Suppose the impact on the interest rate of a \$3 increase in government spending can be eliminated by a \$1 increase in the money supply. If "the" multiplier is 4 and the income multiplier with respect to the money supply is 3, what mix of monetary and fiscal policy is required to increase income by \$6000 without changing the interest rate?

- a) increase G by 900 and increase M by 800
b) increase G by 1500 and increase M by 500
c) increase G by 1200 and increase M by 400
d) increase G by 3000 and decrease M by 2000

31. Suppose the interest rate is 8%, and a bond with an annual coupon of \$90 matures in one year's time, paying its face value of \$1000. This bond's current price should be

- a) below \$1000 b) \$1000 c) above \$1000 d) not enough information to tell

32. Suppose that 30 days ago a friend bought a new 90-day treasury bill with a face value of \$1000, paying \$976. Your friend now wants to sell this bond. If the current annual interest rate is 12%, what should be the approximate market price for this T-bill?
a) \$976 b) \$980 c) \$984 d) \$988
33. The market price of a bond will decrease by the greatest amount if it
a) matures in 3 years and interest rates fall b) matures in 3 years and interest rates rise
c) matures in 10 years and interest rates fall d) matures in 10 years and interest rates rise
34. If the rate of growth of the money supply is seen to increase in a fully-employed economy, the prices of
a) 10-year and 1-year bonds should both rise
b) 10-year and 1-year bonds should both fall
c) 10-year bonds should rise and of 1-year bonds should fall
d) 10-year bonds should fall and of 1-year bonds should rise
35. Which of the following is the Keynesian interpretation of the sequence of events following an expansionary monetary policy?
a) increased i causing decreased I causing increased Y
b) decreased i causing decreased I causing increased Y
c) decreased i causing increased I causing increased Y
d) increased i causing increased I causing increased Y
36. As interest rates rise the demand for money
a) rises because bond prices fall b) falls because people want more liquid assets
c) rises because the rate of return to loaning money is greater
d) falls because the opportunity cost of holding money is higher
37. Which of the following causes M1 demand to decrease?
a) a fall in the tax rate b) an increase in income
c) a fall in the interest rate d) an increase in the use of credit cards
38. The near-term effect of an unexpected sale of bonds by the central bank is
a) an increase in interest rates, a rise in investment and a rise in GDP
b) an increase in interest rates, a drop in investment and a drop in GDP
c) a decrease in interest rates, a rise in investment and a rise in GDP
d) a decrease in interest rates, a drop in investment and a drop in GDP
39. A sale of bonds by the central bank should cause
a) a fall in the interest rate b) an increase in the money supply
c) a decrease in the reserves of the commercial banks
d) an increase in the commercial banks' loans to the public
40. The correct ordering of the intermediate steps of the chain of causation from a change in central bank policy to a change in GDP is the central bank
a) sells bonds, lowers price of bonds, increases i rate, decreases $aggDg\&s$
b) sells bonds, lowers price of bonds, decreases i rate, increases $aggDg\&s$
c) buys bonds, increases price of bonds, increases i rate, increases $aggDg\&s$

d) buys bonds, increases price of bonds, decreases i rate, decreases aggDg&s

41. If in a less-than-fully-employed economy the Fed wanted to reduce interest rates it could do which of the following: (i) buy government bonds on the open market or (ii) bid up the price of treasury bills at the weekly T-bill auction.

a) (i) or (ii) b) (i) not (ii) c) (ii) not (i) d) neither (i) nor (ii)

42. An expansionary fiscal policy at less than full employment should

a) have no effect on the interest rate because the money supply is unchanged
 b) raise the interest rate because higher income increases the demand for money
 c) lower the interest rate because higher income and lower interest rates go together
 d) lower the interest rate because higher income increases investment which is inversely related to the interest rate

43. The limit of an economy's total productive capacity at any given time is set by

a) the amount of money in circulation b) business demand for goods and services
 c) the level of government spending and taxation
 d) the quantity and quality of its productive resources

44. A major advantage of monetary over fiscal policy is that monetary policy

a) can be put into effect more quickly b) affects all sectors of the economy equally
 c) authorities are quicker to see the need for policy
 d) has a more direct and predictable impact on spending

45. "Federal Reserve Chairman Alan Greenspan last week told Congress the economy is showing some signs of strain, notably tightness in the labor markets, and said Fed policymakers stood ready to raise or lower interest rates if necessary to maintain the nation's economic expansion." The Fed would likely

a) lower interest rates if inflation developed
 b) raise interest rates if labor markets became tighter
 c) raise interest rates if labor markets became looser
 d) lower interest rates if labor markets became tighter

46. "The ____ in market rates, which analysts said has helped keep stock prices more or less flat since the beginning of the year, has ____ bondholders." The blanks are best filled with

a) rise; helped b) rise; hurt c) fall; helped d) fall; hurt

47. "Stocks fell yesterday as the movement in rates rekindled concerns about stock market valuations. The Dow Jones industrial average closed down just 33 points but was off by as much as 166 points at one point because of" This clipping is best completed with

a) rising interest rates b) falling interest rates
 c) rising unemployment rates d) falling unemployment rates

48. "Higher interest rates would outweigh upward revisions in earnings estimates resulting from stronger than expected economic growth, said Douglas Cliggotte, a market strategist at J.P. Morgan & Co." This is an argument for expecting stock prices to

a) rise b) fall c) wander aimlessly d) can't tell what might happen to stock prices

49. "The Federal Reserve must continue to evaluate, among other issues, whether the full extent of the policy easings undertaken last fall to address the seizing-up of financial markets remains appropriate as those disturbances abate." Analysts said the words caused some owners of Treasury securities to sell. Owners of Treasury securities sold because they

- a) expected interest rates to fall
- b) didn't want to have their securities seized
- c) were worried that the Fed would loosen monetary policy
- d) were worried that the Fed would tighten monetary policy

50. "Meanwhile, investors prepared for as much as \$6 billion in corporate-bond sales this week by _____ Treasuries to hedge against a _____ in interest rates." The blanks are best filled with

- a) buying; fall
- b) buying; rise
- c) selling; fall
- d) selling; rise

51. "The bond market's benchmark security, the 30-year Treasury bond, rose \$12.50 for every \$1,000 face amount. The bond's yield _____ from _____ to 5.69%." The blanks are best filled with

- a) rose; 4.44%
- b) rose; 5.65%
- c) fell; 6.94%
- d) fell; 5.73%

52. "Some portfolio managers were forced to buy securities in the 10-year to 30-year sector to meet targeted returns for the month and to extend duration, traders said." A higher duration most likely implies

- a) higher returns and more sensitivity of the portfolio to interest rate changes
- b) lower returns and more sensitivity of the portfolio to interest rate changes
- c) higher returns and less sensitivity of the portfolio to interest rate changes
- d) lower returns and less sensitivity of the portfolio to interest rate changes

53. "A 20-year government bond paying 10.25 percent was selling for \$1,007.10, priced above its par value of \$1,000 to yield 10.15 percent." The coupon on this bond is

- a) \$101.50 and the current interest rate is 10.15 percent
- b) \$101.50 and the current interest rate is 10.25 percent
- c) \$102.50 and the current interest rate is 10.15 percent
- d) \$102.50 and the current interest rate is 10.25 percent

54. "Prices in all areas of the bond market traded in a narrow range for most of the week, but jumped sharply yesterday morning in reaction to the news that the U.S. Senate voted to approve specific deficit reduction measures." Bond prices jumped because if the deficit is reduced

- a) interest rates should fall
- b) interest rates should rise
- c) unemployment should fall
- d) unemployment should rise

55. "Over the past six years, the government's share of total borrowing in the U.S. credit markets has fallen to 6% from 60%. That has played a major role in _____ interest rates." The blank is best filled with

- a) stabilizing
- b) increasing
- c) decreasing
- d) inflation-proofing

56. "Bonds, however, turned up on news of strong tax revenue. It is now projected that there could be a budget surplus of as much as \$39 billion, much higher than the \$18 billion forecast." From this information it would be reasonable to conclude that

- a) interest rates should rise
- b) the supply of bonds should fall
- c) the money supply should decrease
- d) government spending should increase by \$21b

57. "If the economy is picking up and the Fed is printing money, it seems to me that the market has good reason to worry." The market is worried because

- a) interest rates should fall
- b) bond prices should fall
- c) taxes should rise
- d) the government deficit should increase

"The White House budget director said that the \$787 billion economic stimulus package (increasing the 2009 estimated deficit to \$1.84 trillion, at 12.9% of GDP the largest since 1945, combined with the Fed cutting the target interest rate for overnight loans between banks, will help" The next two questions are based on this clip.

58. The interest rate for overnight loans is called

- a) The discount rate
- b) The bank rate
- c) The federal funds rate
- d) The overnight cash rate.

59. This economic stimulus package is an example of

- a) fiscal policy
- b) monetary policy
- c) a balanced-budget multiplier
- d) the money multiplier

60. "In an endeavor to minimize the worst of the 2008 downturn, governments worldwide are running up huge debts." This policy is called

- a) fiscal policy
- b) monetary policy
- c) debt policy
- d) interest rate policy

61. "When the U.S. Federal Reserve Board cuts its interest rates, the stock market typically goes up." What logic lies behind this observation?

- a) the lower interest rate increases the price of bonds
- b) at current earnings the return to holding stocks becomes higher than the return to holding bonds
- c) the Fed buys stock to make interest rates fall
- d) at lower interest rates the stock market is riskier and so requires a higher price to compensate

62. "If the 10-year note tops 4.6%, last year's peak yield, it could spark panic selling that could cause rates to" The best way to complete this clipping is

- a) fall dramatically
- b) rise dramatically
- c) freeze
- d) can't tell what rates might do

63. "The FOMC next meets on Oct.28 and 29. Between now and then, officials will consider whether additional cuts are likely to have their desired effect." What kind of cuts are being discussed here?
- a) tax cuts b) money supply cuts c) interest rate cuts d) government spending cuts
64. "In the face of the major recession that seems certain to follow the financial crisis sparked by the sub-par mortgage fiasco, the responsible thing now is to give the economy the help it needs." What kind of help is being referred to here?
- a) lower spending and lower interest rates
 - b) lower spending and higher interest rates
 - c) deficit spending and higher interest rates
 - d) deficit spending and lower interest rates
65. "The Fed has responded to the sub-prime mortgage crisis by easing the supply of liquidity. This does not necessarily mean that the federal funds rate will be cut." Why would easing the supply of liquidity not necessarily imply a fall in the federal funds rate?
- a) liquidity is not the same thing as the money supply
 - b) an increase in liquidity should increase the federal funds rate
 - c) the demand for money may have increased by the increase in the supply of liquidity
 - d) cutting the federal funds rate is the wrong thing to do here

Answers: 1a 2c 3a 4b 5d 6c 7a 8b 9a 10b 11b 12a 13d 14d 15c 16d 17b 18b 19c 20a 21d 22d 23d 24c 25a 26c 27c 28d 29a 30c 31c 32b 33d 34b 35c 36d 37d 38b 39c 40a 41a 42b 43d 44a 45b 46b 47a 48b 49d 50d 51d 52a 53c 54a 55c 56b 57b 58c 59a 60a 61b 62b 63c 64d 65c

Chapter 11: Real versus Nominal Interest Rates

1. "Corporate treasurers should not be frightened by the recent rise in interest rates on bonds. Rates of even 13 percent will look like bargains if inflation heats up over the next 18 months." Rates of 13% will look like bargains because
- a) interest rates will fall if inflation increases
 - b) bond prices are sure to rise in the near future
 - c) interest rates are sure to fall in the near future
 - d) interest rates will rise if inflation increases
2. "Capacity utilization, at 82.4%, was unchanged in January for mines, factories and utilities. Economists are worried that demands on industry may soon outstrip capacity, thereby encouraging producers to raise prices. Inflation, the undisputed Achilles heel of bonds, would result."
- Explain why inflation is the Achilles heel (weak spot) of bonds.
- a) inflation increases the price of everything, including the price of bonds
 - b) inflation means government needs more financing and so bond prices rise

- c) inflation increases the nominal interest rate and so decreases the price of bonds
- d) inflation increases the nominal interest rate which makes bonds too expensive to buy

3. "This brings us back to the fears of higher interest rates before the market break. These fears are still potent, especially if investors see through the temporary reduction in interest rates made possible by stepping up the rate of creation of the money supply."

This reduction in interest rates is thought to be only temporary because

- a) the central bank has no real control over the interest rate
- b) inflation expectations will rise, increasing the interest rate
- c) the money supply and interest rates are positively correlated
- d) the central bank will not have the courage to stick to this policy

4. "The bond markets were stunned by the shock of Thursday's flash second-quarter news that the economy has grown three whole percentage points. Add that discomfoting prospect to the other horrifying disclosure - that, at last reading, our money supply had climbed by a mammoth \$4.8 billion - and you'll know why people were heading for the bond market exits." People are heading for the bond market exits because they suspect that

- a) inflation will fall
- b) interest rates will increase
- c) interest rates will decrease
- d) something illegal is happening

5. "And many borrowers fear that if American inflation can't be whipped, American bond markets may evolve into replicas of Europe's capital markets - surrendering their status as providers of long-term, fixed-cost funds to government and industry." Long-term bonds will lose favor if inflation is not whipped because

- a) their prices will become too high
- b) their prices will become too volatile
- c) the Fed will refuse to buy or sell them
- d) the Fed will cut these bonds' interest rates

6. "The Fed chairman added that the principal misunderstanding about the Fed's role in the present situation is that the Fed could achieve more or less immediately a low level of interest rates if it wanted to." Why can't it achieve immediately a low interest rate if it wanted to?

- a) because velocity is unstable
- b) it could - this is just Fed rhetoric
- c) because it requires lowering inflation which takes time
- d) because Fed control over the money supply is incomplete

7. "Investing in debt securities is a gamble on the government's prudence. The budget makes it clear that the government has taken this task to heart. It stresses the fact that the deficit will be covered by sales of bonds to the general public and not to the central bank." This gamble is more likely to be successful if the bonds are sold to the general public rather than to the central bank because

- a) capital losses are less likely
- b) inflation is likely to be higher
- c) bond prices are likely to be lower
- d) the interest rate is likely to be higher

8. "It had been feared that more good economic readings would trigger a sell-off in the bond market, which typically responds negatively to such news because....." Complete this clipping.

- a) inflation expectations may rise, raising the interest rate

- b) the Fed may react by raising the interest rate
 c) usually such news foretells a fall in interest rates d) both a) and b) above

9. "A smaller-than-expected decrease in the U.S. money supply dealt the North American capital market a hard blow, as bond prices sagged across a broad front." Bond prices sagged because

- a) inflation fears caused a rise in the interest rate
 b) inflation fears caused a fall in the interest rate
 c) the fall in the money supply increased interest rates
 d) the fall in the money supply decreased interest rates

10. "Swings in the price of bonds reflected a high degree of uncertainty about inflation and changing perceptions in the market. The release of figures that showed the economy to be stronger than expected tended to push prices _____ and yields _____ ." The blanks are best filled with

- a) higher; higher b) higher; lower c) lower; higher d) lower; lower

11. "One view in the market has been that because the economy seemed weaker than it should be, the Federal Reserve Board would cut its discount rate from 7.5 percent. This, of course, would be positive for bonds. On the other hand, there have been those thinking that rising money-supply growth would rule out such a discount rate reduction." Why would rising money-supply growth rule out a discount rate reduction?

- a) it would raise expected inflation and thus interest rates
 b) it shouldn't - the clipping is wrong - rising money supply growth should lower interest rates
 c) a rise in the discount rate is required for the Fed to be able to increase the money supply
 d) to increase the money supply the Fed needs to sell bonds which lowers their price, increasing the interest rate

12. "Analysts say the three-month rally in bonds has been fuelled by Washington's promise to balance its budget by 1991 and OPEC's decision to abandon support for world oil prices in the short run." The bond rally is because

- a) unemployment should fall b) inflation fears have increased
 c) interest rates are expected to fall
 d) everyone is optimistic about future economic prosperity

13. "News of economic weakness last week cleared the way for higher bond prices. The New York market moved quickly to capitalize on this good bad news: prices shot up more than a point in minutes." Bond prices rose because

- a) inflation expectations fell b) higher prosperity is coming
 c) unemployment is expected to fall d) the Fed is expected to raise interest rates

14. "The Fed is scrambling hard to keep interest rates from increasing in the face of renewed inflationary pressures, but the banking industry is a lot less interested in cooperating with the Fed because of the rising loan demand they are facing." Loan demand is rising because

- a) real interest rates are low b) real interest rates are high

c) people have confidence in the Fed d) inflation expectations are falling

15. "Producer prices crept up a modest 0.2 percent in April, the government said yesterday in a report that could give the Federal Reserve room to cut interest rates again in a bid to boost the slowly recovering economy." The Fed can cut interest rates because

- a) inflationary expectations have fallen
- b) the recession demands stimulating monetary policy
- c) no recovery is possible without a fall in interest rates
- d) the clipping is wrong - the Fed controls the interest rate and can cut it whenever it wants

16. "The Franklin Savings bonds will carry a 3 percentage point premium over inflation. This deal takes the uncertainty out of the inflation component." An investor will be better off buying this bond (rather than a regular bond) if the current market expectation of inflation is

- a) accurate b) an overestimate
- c) an underestimate d) it doesn't matter - an investor is guaranteed to be better off

17. "As a result, interest rates, which particularly affect certain sectors (capital spending, houses, and cars) are raised to levels which were previously viewed as impossible. But clearly, they aren't out of line with what the central bank views as appropriate." Interest rates could rise to such high levels because of

- a) high inflation expectations b) huge central bank bond sales
- c) large increases in the price of bonds d) the central bank following a monetarist rule

18. "Moreover, contrary to the central bank's pronouncements, higher interest rates have not caused everyone to borrow less. Most people are borrowing as much as ever - or more - to buy goods now." Why have higher interest rates not led to a fall in borrowing, as standard economic theory suggests should happen?

- a) current price levels are very low b) unemployment is particularly low
- c) real interest rates are in fact very low d) nominal interest rates are in fact very low

19. "When you look at real interest rates, they're way too high, probably because most people are still determining whether low inflation is a long-term reality." Real interest rates are high because

- a) the Fed has printed too much money b) the Fed has failed in its fight against inflation
- c) inflation expectations are lower than actual inflation
- d) inflation expectations are higher than actual inflation

20. "A decline in the rate of inflation is the one sure route to lower interest rates, the central bank told us two years ago. Inflation is now only about one-third of what it was two years ago, but interest rates are higher. How come?" The promised results have not materialized because

- a) the demand for money has fallen b) the supply of money has increased
- c) inflation expectations have not fallen d) interest rates and inflation are not connected

21. "In his eyes the battle is between the rate-lowering effect of the recession and the high rate of inflation. That sums up the problem now facing the interest rate forecasters."

A recession tends to lower the interest rate because

- a) the Fed may lower interest rates to fight the recession
- b) the government may increase spending to fight the recession
- c) income falls in a recession causing the demand for money to fall
- d) both a) and c) above

22. "In one camp are those who think interest rates will either stabilize or move up because the economic outlook is improving and will rebound from the paltry 0.7 percent real growth in the gross domestic product in the first quarter. Moreover, they argue, growth in money supply has been way above the Fed's target." Interest rates are expected to rise for all of the following reasons except

- a) inflation expectations should increase
- b) the demand for money should increase
- c) the Fed should tighten monetary policy
- d) bond prices should rise as the economy recovers

23. "In economic theory, money is a commodity that responds to the law of supply and demand. When the supply of money rises, the price - the interest rate - should drop. But the market for money is perverse. When lenders see the money supply increasing, they think" Complete this clipping.

- a) inflation will increase
- b) the real interest rate will increase
- c) the nominal interest rate will fall
- d) demand for money must have increased

24. "The past few years have been, in effect, a crash course in basic economics for investors and others with a hand in the game. They're much harder to fool now with actions that seem to improve the situation in the short run but make it worse in the long run." An example of a policy action that improves the situation in the short run but makes it worse in the long run is

- a) a supply-side policy which lowers the price level in the short run but increases it in the long run
- b) a decrease in taxes which increases disposable income in the short run but decreases it in the long run
- c) an increase in the money growth rate which lowers the interest rate in the short run but raises it in the long run
- d) an increase in government spending which lowers unemployment in the short run but increases it in the long run

25. "The principal power of the central bank to lower interest rates lies in its ability to contribute to a lower rate of inflation and that takes time." Lower inflation means lower interest rates because

- a) money supply is higher
- b) money demand is lower
- c) expected inflation is lower
- d) investment demand is lower

26. "Bond prices soared and yields plunged after the Labor Department said the producer price index rose by 0.4 percent in March. Although Wall Street had been expecting a rise of only 0.3 percent, the core index, excluding the volatile food and energy sector, rose a slight 0.1 percent against expectations of a 0.3 percent rise." Bond prices soared because

- a) inflation expectations increased b) inflation expectations decreased
- c) yields plunged due to supply of bonds exceeding demand for bonds
- d) of uncertainties due to irregularities in reporting the monthly price index

27. "Although the Fed has been successful in pushing down short-term interest rates to 4 percent, the long bond yield has fallen very little and is still up at 7.5 percent." The yield on the long bond is higher than on short-term bonds because

- a) the demand for long-term bonds must be greater than for short-term bonds
- b) the Fed must be selling many more long-term bonds than short-term bonds
- c) long-run inflation expectations must be higher than short-run inflation expectations
- d) long-run inflation expectations must be lower than short-run inflation expectations

28. "I think the bond market's got room on the upside. With real rates so high and inflation looking like its not coming back, there's room for further rally." Which of the following is an explanation for this?

- a) bondholders love high real interest rates
- b) the Fed should soon reduce the rate of money growth
- c) interest rates should fall because inflation expectations should fall
- d) bond prices should rise because the nominal interest rate should rise

29. "The recent surge in the money supply must be contained, and in very short order, if the hope for a viable long-term bond market is to be sustained." The problem here is that this surge can cause

- a) higher long-term interest rates which will lower long-term bond prices
- b) higher long-term interest rates which will raise long-term bond prices
- c) lower long-term interest rates which will lower long-term bond prices
- d) lower long-term interest rates which will raise long-term bond prices

30. "The 'core' measures of producer and consumer price inflation, which exclude the volatile food and energy components, were above Wall Street's estimates. The figures sparked heavy _____ in the bond market, where the 30-year bond yield _____ one-quarter of a percentage point in just two days." The blanks are best filled with

- a) buying; rose b) buying; fell c) selling; rose d) selling; fell

31. "Monetary policy, by winning on inflation, is about to confer to the federal government an enormous fiscal dividend." This is because lower inflation means

- a) higher income which means higher tax revenues
- b) lower government spending on goods and services, which reduces the budget deficit
- c) lower nominal interest rates which means less government spending on interest payments, which reduces the budget deficit
- d) the clipping is wrong - there is no connection between monetary policy and the budget deficit

32. "High interest rates are unquestionably anti-inflationary. Despite this, people no longer believe an increase in interest rates is a sign that inflation is about to be beaten. Quite the opposite. People now take a jump in interest rates as a sign that inflation is about to get worse." This happens because higher interest rates mean that the

- a) demand for money has increased b) Fed has given up fighting inflation

- c) the cost of doing business has increased
- d) the expected inflation premium in the nominal interest rate has risen

33. "Consumer prices rose just 0.1 percent in July from June. While the increase from a year earlier is 2.8 percent, inflation in the last three months is a mere 0.8 percent annualized. As a result, the long bond plunged to a new low of 6.33 percent from 6.63 percent a week earlier." The long bond plunged because

- a) lower inflation expectations increased the nominal interest rate and decreased the price of bonds
- b) lower inflation expectations decreased the nominal interest rate and increased the price of bonds
- c) higher inflation expectations increased the nominal interest rate and decreased the price of bonds
- d) higher inflation expectations decreased the nominal interest rate and decreased the price of bonds

34. "The reason for Clinton's caution is obvious: the bond market sent him a signal a month ago that big spending is just not acceptable. In anticipation of Clinton's victory, coupled with talk from the Clinton camp about fresh spending, the sell-off of treasury bonds boosted long-term interest rates to about 7.7 percent from 7.3 percent." Interest rates rose because people think

- a) taxes will rise
- b) bond prices will rise
- c) more government bonds will be sold
- d) there will be a big decrease in the money supply

35. "But she warns that any major attempt to reduce rates for the sole purpose of cutting the federal government's huge interest payments on the public debt would likely backfire and drive rates higher." It could backfire and drive rates higher because it could

- a) create inflation, raising the nominal interest rate
- b) require higher taxes which would push up interest rates
- c) involve open market bond sales which would increase the public debt
- d) create unemployment, reducing taxes and increasing the budget deficit

36. "Helping to spark yesterday's bond rally was a major _____ in oil prices." The blank is best filled with

- a) rise, because it means interest rates will rise
- b) rise, because it means interest rates will fall
- c) fall, because it means interest rates will rise
- d) fall, because it means interest rates will fall

37. "So it will be impossible for monetary authorities to get long-term interest rates down unless they can convince lenders they can hold down the _____ rate." Fill in the blank.

- a) tax
- b) savings
- c) inflation
- d) unemployment

38. "Bond prices sank on news that the unemployment rate fell to its lowest point in January in a year, to 7.1 percent, but then strengthened after the numbers proved too good to be true. On closer examination, most of the decline was caused by reductions in the labor force." Why would the fact that the decline was due to labor force reductions push bond prices back up?

- a) inflation fears were alleviated
- b) actual unemployment had been overestimated
- c) employment rose by more than had been thought
- d) the economy is closer to full capacity than had been thought

39. "The drop in sales provided a boost to the credit market where many analysts believe a slowing economy would relieve upward pressure on interest rates." A slowing economy leads to lower interest rates because

- a) lower income means a lower demand for money
- b) the Fed may lower rates to stimulate the economy
- c) inflationary pressures are lower, dropping inflation expectations
- d) all of the above

40. "Comments by Alan Greenspan, chairman of the Federal Reserve Board, have intensified speculation that inflation will remain subdued and prompted some investment managers to predict even further _____ in interest rates. Prices of some actively traded 30-year Treasury bonds wound up the day with _____ of about three-quarters of a point, or about \$7.50 per \$1,000 face amount." The blanks are best filled with

- a) rises; an increase
- b) rises; a decrease
- c) falls; an increase
- d) falls; a decrease

41. "This inflation-indexed bond is structured so that the coupon payments are 4.25 percent, and the principal is adjusted as inflation changes over the life of the bond. The issue met stiff opposition." From this information, the current real interest rate is

- a) equal to 4.25%
- b) less than 4.25%
- c) greater than 4.25%
- d) greater than current inflation

42. "Bond traders, worried about inflation, have bid long rates up above 8 percent, raising real interest rates to 5 percent." Current inflation is

- a) less than 3%
- b) 3%
- c) 5%
- d) more than 5%

43. "Continued relief that the slowly growing economy is not producing significant levels of inflation moved the 30-year benchmark treasury bond to \$103.28 to yield 7.30 percent versus 7.35 percent a week earlier." The price of this bond last week was

- a) less than \$103.28
- b) \$103.28
- c) more than \$103.28
- d) insufficient information to tell

44. The current price of a Treasury bill due to pay \$1,000 in one year's time is \$930. If the central bank announces that the money supply growth rate will jump from 6% to 8%, the interest rate should soon become about

- a) 9%
- b) 9.5%
- c) 10%
- d) not enough information to forecast

45. The current price of a Treasury bill due to pay \$1,000 in one year's time is \$930. If the central bank announces that the money supply growth rate will jump from 6% to 8%, the price of this Treasury bill should soon

- a) fall
- b) remain unchanged
- c) rise
- d) not enough information to forecast

46. If the money supply is growing at 9%, the real interest rate is 3%, the real rate of growth of GDP is 2%, and financial innovations are reducing the demand for money by 1% per year, the nominal interest rate is

- a) 8%
- b) 9%
- c) 10%
- d) 11%

47. Suppose the real interest rate is 3%, the real growth rate is 2%, the money multiplier is 4, banking innovations are decreasing the demand for money by 1% per year and the money supply is growing at 10% per year. What should be the price of a T-bill due to mature in one year at its face value of \$1,000?

- a) less than \$895 b) more than \$895 but not more than \$900
c) more than \$900 but not more than \$905 d) more than \$905

48. Suppose interest income is taxed at 50%. If the real interest rate is 3%, how much extra tax is paid on interest earned from \$10,000 when expected inflation is 6% rather than 2%?

- a) \$150 b) \$200 c) \$250 d) \$400

49. Suppose velocity is increasing at 1% per year, the real rate of growth of the economy is 2%, the real interest rate is 3%, and the rate of growth of the money supply is 4%. The nominal interest rate should be approximately

- a) 4% or less b) 5% c) 6% d) 7% or more

50. If the interest rate exceeds 15%, the most appropriate policy for lowering it is

- a) decreasing the money growth rate b) lowering the discount rate
c) increasing the money supply d) restricting capital inflows.

51. If the rate of money growth increases in a fully-employed economy you should

- a) wait to see what happens b) buy bonds because their price should soon rise
c) sell bonds because their price should soon fall
d) not worry because bond prices should not change

52. If monetary policy targets on an unemployment level less than the natural rate of unemployment, then over time

- a) the interest rate should rise b) the exchange rate should rise
c) both real and nominal wages should fall
d) the interest rate and GDP should remain roughly constant

53. If in a fully-employed economy the rate of growth of the money supply is seen to increase, then soon

- a) both long- and short-term bond prices should rise
b) both long- and short-term bond prices should fall
c) long-term bond prices should rise and short-term bond prices should fall
d) long-term bond prices should fall and short-term bond prices should rise

54. The real interest rate is the

- a) nominal interest rate less the expected rate of inflation
b) nominal interest rate plus the expected rate of inflation
c) observed interest rate less the expected rate of inflation d) both a) and c) above

"A February employment report that wasn't particularly weak--there were 275,000 new payroll jobs--sparked a major rally Friday because it didn't point to the blockbuster growth that many investors and traders had expected. It was a "relief rally," said one

analyst. The unemployment rate ticked up to 4.4 percent from 4.3 percent, but the most soothing news was a small 0.1 percent increase in average hourly earnings. That suggested that strong growth still isn't sparking more inflation, and therefore the Federal Reserve can remain on hold, a number of analysts said."

55. The unemployment rate increased despite so many new payroll jobs because

- a) more than 275,000 jobs were expected
- b) the labor force increased by more than 275,000
- c) discouraged workers increased by more than 275,000
- d) payroll jobs don't count in the unemployment figures

56. The "brief rally" refers to a rise in

- a) growth
- b) inflation
- c) bond prices
- d) interest rates

57. It was expected that the Fed would

- a) tighten monetary policy
- b) loosen monetary policy
- c) offset the rise in unemployment
- d) increase the money supply

58. "Indexed bonds - also known as real-return bonds - pay investors an annual rate of interest plus the inflation rate from that year. If the government really believes that its inflation targets will be met, it should issue more indexed bonds. This would minimize its interest costs because" This is best completed with

- a) inflation would be lower
- b) lenders would experience capital gains on their bonds
- c) purchasers would not have to be compensated for the risk of unexpected inflation
- d) interest payments would be calculated using the real rate rather than the nominal rate

59. "For one thing, the current economy doesn't look the way it generally has in the past when the Fed has embarked on a series of rate increases. Real, or inflation-adjusted, interest rates, for example, already are high, not low. That's because _____ has been falling _____ than interest rates." The blanks are best filled with

- a) inflation; faster
- b) inflation; slower
- c) unemployment; faster
- d) unemployment; slower

60. In addition, some economists argue that there is useful information contained in the yields of non-indexed and indexed government bonds. The difference in the two yields is a market-based signal of _____. The blank is best filled with

- a) expected inflation
- b) the money growth rate
- c) unemployment
- d) the real growth rate

61. "A chorus of inflation-related worries pushed down stocks, bonds and the dollar. The bellwether 30-year Treasury bond, for example, _____ \$12.50 per \$1,000 bond. Traders blamed the broad-based change on worries that the Federal Reserve might be preparing to _____. The blanks are best filled with

- a) rose; tighten monetary policy
- b) rose; loosen monetary policy
- c) fell; tighten monetary policy
- d) fell; loosen monetary policy

62. "Bond prices edged lower as investors trimmed holdings ahead of today's monthly U.S. jobs report." Investors are worried that the monthly jobs report may show

a) strong job growth b) weak job growth c) no job growth d) a decline in jobs

63. "On Wall street, inflation alarms are ringing. Higher inflation is on the way, warns one trader who expects inflation to rise to 5 percent next year. Judging from market action in recent days, many other bond traders seem to agree." Bond traders must have been

a) selling bonds, raising the interest rate b) selling bonds, lowering the interest rate
c) buying bonds, raising the interest rate d) buying bonds, lowering the interest rate

64. "The U.S. bond market is betting that inflation is about to pick up, shortening the odds that the Federal Reserve will soon _____"

What is happening to prices on the bond market, and how is the blank is best filled ?

a) prices are increasing; raise interest rates b) prices are increasing; lower interest rates
c) prices are decreasing; raise interest rates d) prices are decreasing; lower interest rates

65. "Based on last year's inflation expectations, lenders and borrowers agreed on the nominal interest rate to be paid on loans. But now, in retrospect, borrowers are clear losers.." This happened because inflation turned out to be

a) higher than expected b) lower than expected
c) exactly as expected c) more volatile than expected

"The damaging effect to the marketplace created by the persistence of heavy government borrowings is an ever-present concern for bond investors. A fear is that the solution to the government's seemingly insatiable appetite for funds will be debt monetization. As a result, most observers expect interest rates to remain historically high."

66. Debt monetization will

a) raise bond prices b) lower bond prices
c) increase the deficit d) decrease the deficit

67. Interest rates remain high primarily because of

a) tight monetary policy b) fear of future inflation
c) unemployment worries d) fear of future tax increases

68. "High interest rates, not the deficit, are the country's major problem. It is high interest rates that have caused unemployment which in turn has cut into government revenues and forced up spending, adding to the deficit." Which of the conclusions below is the least reasonable to draw?

a) the deficit has resulted from high unemployment
b) the high interest rates have resulted from high inflation
c) the high unemployment has resulted from fighting inflation
d) the monetary authorities should increase the money supply to attack unemployment and lower interest rates

69. "Price-level targeting is the latest suggestion for monetary policy. This policy would target on an inflation rate measured over the next three years, say, rather than over the next year." The advantage of this proposal is that monetary policy would

a) hold the rate of growth of the money supply constant

- b) fix the interest rate
- c) target on the inflation rate
- d) allow short-term deviations from a targeted inflation rate

“By raising and lowering short-term interest rates to keep inflation moving at a steady pace, many central bankers and academics thought they had finally found a monetary policy solution to conquer the booms and busts of the business cycle.” The next two questions are based on this clip.

70. This monetary policy is described as
- a) fixing the rate of growth of the money supply
 - b) targeting on the inflation rate
 - c) fixing the interest rate
 - d) accommodation
71. By following this policy interest rates would be
- a) lowered in a boom and lowered in a recession
 - b) lowered in a boom and raised in a recession
 - c) raised in a boom and lowered in a recession
 - d) raised in a boom and raised in a recession
72. “Analysts said there is little reason for Treasuries to break out of recent ranges until there are clearer signs that either growth is slowing or inflation is picking up.” Which of the following should both lead one to expect an increase the price of Treasuries?
- a) slower growth and higher inflation
 - b) slower growth and lower inflation
 - c) higher growth and higher inflation
 - d) higher growth and lower inflation
73. “The Fed took a somewhat more hawkish view of inflation than it did in the March statement. Today’s statement made specific reference to inflationary pressures, saying that energy and other commodity prices have increased, an acknowledgement absent from the March statement.” This statement suggests that the Fed will move to a
- a) tighter monetary policy, raising interest rates
 - b) tighter monetary policy, lowering interest rates
 - c) easier monetary policy, raising interest rates
 - d) easier monetary policy, lowering interest rates
74. “This suggests a shift in the FOMCs assessment away from concern over economic growth towards concern over inflation.” This statement suggests that the Fed will move to a
- a) tighter monetary policy, raising interest rates
 - b) tighter monetary policy, lowering interest rates
 - c) easier monetary policy, raising interest rates
 - d) easier monetary policy, lowering interest rates
75. Subtle changes in the wording of the FOMCs statement suggest that the Fed is

becoming more hawkish on inflation and so is probably near the end of its cycle of” This statement is best completed by

- a) tax increases
- b) tax cuts
- c) interest rate increases
- d) interest rate cuts

76. “To stimulate the economy the government could give money away. The danger here is that it could trigger a bond market crash.” This would happen because

- a) the extra wealth would bid up bond prices
- b) the extra money would cause inflation
- c) the extra wealth would increase unemployment
- d) the extra money would lower interest rates

77. “The European Central Bank is becoming increasingly anxious about persistently strong money supply growth; dynamic growth in M3, a broad measure of money supply, is being seen at the ECB as _____ and is strengthening arguments against _____ despite concern over the fragility of the recovery in the eurozone.” The blanks are best filled with

- a) an inflationary danger; an interest rate cut
- b) an inflationary danger; an interest rate increase
- c) an unemployment danger; an interest rate cut
- d) an unemployment danger; an interest rate increase

78. “The Fed’s latest policy statement made it clear that an accommodative policy will remain in effect until a full-fledged economic recovery arrives.” An “accommodative” policy here means

- a) a tight monetary policy
- b) an easy monetary policy
- c) a tight fiscal policy
- d) an easy fiscal policy

79. “Core prices, as measured by the Fed’s preferred index based on personal consumption expenditures, are up 2.5 percent over the past year, above the Bernanke comfort zone of 1 to 2 percent.” The implication for monetary policy of going above this comfort zone is that

- a) the money supply should be increased
- b) interest rates should be lowered
- c) monetary policy should be tightened
- d) monetary policy needs to focus on consumer spending

80. “The FOMC next meets on Oct.28 and 29. Between now and then, officials will consider whether additional cuts are likely to have their desired effect of”

This statement is best completed by

- a) decreasing the budget deficit
- b) lowering inflation
- c) stimulating the economy
- d) increasing unemployment

81. “But one bright spot was a sign that U.S. inflation is in check, and economists said that trend, combined with a soft job market, will give the Fed room to” This statement is best completed by
- decrease taxes
 - decrease the money supply
 - decrease interest rates
 - balance the budget
82. “Doubt we could have devastating bank runs? Doubters must explain why people in 2009 who could get 3% interest at their bank instead bought 90-day T-bills yesterday yielding 0.14%.” How can this be explained?
- the T-bills were selling for an extraordinarily low price
 - the Fed was expected to cut interest rates
 - inflation was expected to increase
 - people were worried that their bank might go bankrupt
83. “Just this July financial markets were anticipating a series of interest rate hikes by the Bank of Canada after an initial increase to 4.5%. But the credit market blow-up, on top of the U.S. housing slump, darkened the outlook.” Why would a credit market blow-up and a U.S. housing slump suggest that interest rates will not be hiked?
- inflation has increased
 - the economy needs stimulus now
 - to lower government borrowing costs
 - unemployment has fallen
84. “A combination of a significant upward revision to GDP growth, a downward revision of the output gap, and stronger-than-expected inflation data suggest that soon the central bank will” Which of the following is the best way to complete this statement?
- lower the reserve requirement
 - raise interest rates
 - increase money supply growth
 - raise taxes
- “So it looks like the U.S. economy is in the not-too-hot, not-too-cold sweet spot: it expanded at an estimated 3.4 percent annualized rate, and the core inflation measure eased to 1.8 percent. But check the details: A reduction in inventories in the quarter sliced 2.3 percentage points off the GDP growth number.” The next two questions refer to this clip. Hint: This clip is misleading because inventory changes are already included in the GDP measure.
85. What policy would be most appropriate here?
- lower interest rates and higher government spending
 - lower interest rates and lower government spending
 - higher interest rates and higher government spending
 - higher interest rates and lower government spending
86. How could a reduction in inventories slice the GDP growth number.

- a) The GDP growth number referred to here must be growth in aggregate demand
- b) Actual GDP growth must have been 5.7 percent
- c) Actual GDP growth must have been 1.1 percent
- d) The GDP growth number must include the 1.8 percent price increases

87. "A major revision to last year's inflation numbers yesterday indicated that U.S. inflation had actually been running a half-percentage point higher than the market had previously assumed. This implies that in real terms the Fed's benchmark federal funds interest rate is considerably more accommodative than the Fed had thought. This foretells ..." The best way to complete this clip is

- a) interest rate increases
- b) interest rate decreases
- c) money supply increases but no interest rate change
- d) money supply decreases but no interest rate change

88. "The revision to inflation numbers indicating that inflation has actually been running a half-percentage point higher than the market had thought stirred things up for long-term bonds." What kind of stirring up happened on the bond market? The price of long-term bonds

- a) fell slightly
- b) fell a lot
- c) rose slightly
- d) rose a lot

89. "Currently, the spread between long-term rates and inflation is above average, implying that investors believe that" The best way to complete this statement is

- a) inflation will be higher in the future
- b) inflation will be lower in the future
- c) the Fed will soon lower interest rates
- d) taxes will increase in the future

90. "Canada's interest rates are too low to bring inflation under control. The interest rate that matters for fighting inflation is The contrast between Canada and other countries is revealing. The U.S. has a federal funds rate of 5.25% and inflation of 2.4%; the UK has a bank rate of 5.75 and inflation of 2%; and Australia has its overnight rate at 6.5% and inflation of 2.1%." How would you calculate what must be the Canadian interest rate being referred to here?

- a) the difference between the nominal interest rate and the inflation rate
- b) the Canadian equivalent of the federal funds rate
- c) some measure of the real interest rate
- d) both a) and c) above

91. "While U.S. Treasuries are at record low yields, corporate bonds are at record highs. Corporations are paying an average interest rate of 10.8 per cent on debt, compared with 2.6 per cent on 10-year U.S. Treasuries." This dramatic difference could be caused by

- a) a high inflation rate
- b) a high tax rate
- c) fears of corporate bankruptcy
- d) a low level of government spending

92. "The Fed is expected to lower the Federal funds rate tomorrow, but as far as the economy goes the decision is basically irrelevant. The actual, or effective, Fed funds rate is already close to zero, 0.125 per cent; the Fed funds rate is currently at 1 per cent." The difference between the Federal funds rate and the actual (or "effective") Fed funds rate is

- a) the difference between the real and nominal interest rates
- b) the actual rate of inflation
- c) the difference between the official rate and the rate that banks pay for overnight loans
- d) the difference between the T-bill rate and the prime rate

93. "The Fed is expected to lower the Federal funds rate tomorrow, but as far as the economy goes the decision is basically irrelevant. The actual, or effective, Fed funds rate is already close to zero, 0.125 per cent; the Fed funds rate is currently at 1 per cent."

This large difference could happen because

- a) inflation is high
- b) expected inflation is high
- c) of unusually high money supply growth
- d) of a large government deficit

94. "The issue is whether monetary policy can do the trick or not, and it would appear to many that it can't." Why might monetary policy not be able to alleviate the 2008 recession? Because during a recession

- a) monetary policy is like pushing on a string
- b) a lower interest rate does not increase spending
- c) people are bent on saving, not spending
- d) all of the above

Answers: 1d 2c 3b 4b 5b 6c 7a 8d 9a 10c 11a 12c 13a 14a 15a 16c 17a 18c 19d 20c 21d 22d 23a 24c 25c 26b 27c 28c 29a 30c 31c 32d 33b 34c 35a 36d 37c 38a 39d 40c 41c 42b 43a 44b 45a 46d 47a 48b 49c 50a 51c 52a 53b 54d 55b 56c 57a 58c 59a 60a 61c 62a 63a 64c 65b 66b 67b 68d 69d 70b 71c 72b 73a 74a 75d 76b 77a 78b 79c 80c 81c 82d 83b 84b 85d 86a 87a 88b 89a 90d 91c 92c 93c 94d

Chapter 12: Stagflation

1. "The central bank warned about a possible 'collision' in the future between rising wages and prices and its hold-the-line monetary policy." The result of this collision will be

- a) rising inflation
- b) rising unemployment
- c) falling interest rates
- d) falling deficits

2. "We're not likely to see a really tight monetary policy; he made clear that the central bank is following an 'intentionally moderate' monetary policy in order to 'minimize the strains involved in adjusting to a less inflationary economy.' He points to the 'awkward economic fact that in the short run anti-inflationary policies tend to restrain output more than prices'." In plain language this means that the central bank is adopting a policy of

- a) raising interest rates markedly to cut back on output
- b) gradually reducing the rate of growth of the money supply
- c) attacking unemployment with a policy of gradually increasing the money growth rate
- d) increasing the money supply at a low steady rate equal approximately to the real rate of growth of the economy.

3. "People widely believe that there is a correlation between higher interest rates and capital inflows, but this belief is as false as the once accepted belief that there is a correlation between unemployment and inflation, causing the one to go up when the other goes down. These correlations don't stand up to scientific research." The correlation between unemployment and inflation doesn't exist because

- a) the short-run Phillips curve can shift
- b) in the long run any level of inflation is compatible with the NRU
- c) movements away from and back to the NRU can both be associated with rising inflation
- d) all of the above

4. "She said that there is no evidence we are suffering from either high inventory stocks or a sharp inflationary spike, the two factors that typically cause a major recession." These two factors would typically cause producers to

- a) decrease output and the Fed to decrease the money supply
- b) decrease output and the Fed to increase the money supply
- c) increase output and the Fed to decrease the money supply
- d) increase output and the Fed to increase the money supply

"Just as in the '30s when government intervened to save capitalism from itself, so again must it intervene massively now to save government capitalism from itself. Since government now protects individuals and corporations from the consequences of excessive wage and price increases, government must now prevent those excessive increases by permanent wage and price controls."

5. Government protects individuals and corporations from excessive wage and price increases through

- a) lower taxes
- b) social safety nets
- c) unemployment insurance
- d) monetary accommodation

6. Wage and price controls could succeed in preventing these excessive increases if they

- a) were seen to be permanent
- b) had very high penalties for violation
- c) were accompanied by low interest rates
- d) were accompanied by low money supply growth

"The central bank was presumably trying to maintain very high interest rates and, I assume in the face of political reality and pressure from the economy, released the interest rate a few weeks ago. The monetarists will allow you to go ahead and ruin people and countries but when eventually in good and common sense you say 'enough is enough' the monetarists say 'well, you spoiled the experiment.'"

7. People and countries are being ruined because of high
a) taxes b) inflation c) uncertainty d) unemployment

8. The experiment was to see if
a) unemployment could be lowered quickly
b) high interest rates could be maintained indefinitely
c) inflation could be held steady at a high rate indefinitely
d) holding money growth at a low rate would lower inflation

9. What does releasing the interest rate imply about the central bank's monetary policy?
a) it has become easier b) it has become tighter
c) it is fighting inflation d) it is following a money growth rule

10. "This suggests that wages play a game of catch-up, then fall behind for a while. But on the average, they advance about three percent a year, in real terms. We are still not far off this pace. The only trouble is that the economy is no longer productive enough to yield three percent average wage gains in real terms. If the cycle now goes into the catch-up phase, the demands for real gains to make up for the real losses of the past three years will collide with an economy going into at least a temporary stall." This stall happens because

a) real wages rise too much, creating inflation
b) real wages rise too much, creating unemployment
c) real wages fall too much, increasing the demand for labor and causing inflation
d) real wages fall too much, lowering demand for goods and services and creating unemployment

11. "He favors a slow recovery, for example, because the natural rate of unemployment may turn out to be higher than anyone thinks." Possible underestimation of the natural rate implies that a recovery should be slow because

a) a slow recovery is politically more desirable
b) a fast recovery runs the risk of creating inflation
c) a slow recovery ensures the employment gains are permanent
d) a fast recovery cannot decrease unemployment as effectively

12. "The damnable paradox is that we are also at 'full employment,' or at least at the 'natural rate' of unemployment. This means only that we are at or near the lowest rate to which unemployment can be pushed by expanding demand without" Complete this clipping.

a) requiring higher taxes b) causing higher inflation
c) lowering interest rates d) increasing the NRU

13. "Unemployment rates in Canada and the United States are sufficiently low that employers are having difficulty filling many jobs. The point at which red flags go up, economists say, is nine percent in Canada and six percent in the United States." What danger do the red flags signal?

a) higher taxes b) higher inflation
c) more discouraged workers d) more encouraged workers

14. "Nor will decreases of one percent cuts in interest rates bring anything but more inflation. Nor yet do grand spending programs 'create' more jobs: they only redistribute them, from industry to industry, from region to region, from private sector to public sector." The rationale behind these comments is based on

- a) the multiplier process
- b) a vertical long-run Phillips curve
- c) an upward-sloping short-run Phillips curve
- d) a downward-sloping short-run Phillips curve

15. "The response of the monetary authorities to any hint of inflation is to dampen demand by raising interest rates and slowing economic activity - that is, *by causing a recession*. It always seems to me that one of the great failures of the economic profession is that the only thing it seems to be able to recommend to eliminate inflation is a recession, but that's the way it is." This clipping reflects the short-run trade-off between

- a) equity and efficiency
- b) inflation and interest rates
- c) inflation and unemployment
- d) real and nominal interest rates

"We cannot afford to take any major risks with inflation. If we let inflation get away on us again, even for just a while, the path back to price stability will be even more painful than it has been during the last few years."

16. This painful path will involve

- a) high taxes
- b) high interest rates
- c) high unemployment
- d) both b) and c) above

17. Why would letting inflation get away for only a while require a painful return?

- a) the short-run Phillips curve is asymmetric
- b) inflation expectations rise quickly but fall slowly
- c) the short-run Phillips curve shifts upward quickly but downward slowly
- d) all of the above

18. "'Walk, don't run,' is the message from the monetary authorities. Clearly, their thinking is that what the economy needs now is not a speedy recovery from recession, but one that is slow, drawn out and, in many respects, painful." This is because a speedy recovery

- a) will not create quality jobs
- b) discourages long-term growth
- c) will push interest rates too low
- d) risks pushing the economy below the NRU

19. "The evidence of the 1970s and beyond is that whenever governments stepped in to administer stimulative medicine, they triggered runaway inflation which finally had to be stopped with strong, painful doses of recession." This clipping is consistent with all of the following except

- a) frequent underestimation of the NRU
- b) an asymmetric short-run Phillips curve
- c) inflation expectations rising quickly but falling slowly
- d) the short-run Phillips curve shifting downwards quickly but upwards slowly

20. "He warned yesterday that economic recovery in the Western world could be short-lived if governments injected too much financial stimulus into their economies in an

attempt to boost employment and output." The economic recovery would be short-lived because

- a) crowding out will kill the recovery
- b) the economy would move so quickly out of recession that the "recovery" period would be short
- c) inflation would be created which would be fought by pushing the economy back into recession
- d) an increase in taxes would be required to pay for the extra financial stimulus, dampening economic activity

21. "Since the central bank has not achieved zero inflation in the postwar era, why should individuals believe in such a policy now? If a zero-inflation goal lacks credibility, then an attempt by the central bank to achieve it will" Complete this clipping

- a) create low interest rates and low unemployment
- b) create low interest rates but high unemployment
- c) create high interest rates but low unemployment
- d) create high interest rates and high unemployment

22. "What it does mean is that over-all financial policy must be, and must be seen by a skeptical public to be, consistent with a continuing movement towards cost and price stability." It is important that the public sees this consistency to

- a) reduce expectations of inflation
- b) shift the short-run Phillips curve downward
- c) permit movement down the long-run Phillips curve
- d) all of the above

"But he defended the slow, steady decline in interest rates beginning in the spring of 1989 as the best that could have been done, given the fear of future inflation - a fear that has until recently kept long-term interest rates high despite repeated cuts in short-term rates by the Fed."

23. A faster fall in interest rates was not advisable because

- a) it would have created unemployment
- b) it would have lowered inflation too quickly
- c) it would have worsened fears of future inflation
- d) it was not possible because long-term rates were not falling

24. Long-term interest rates were higher than short-term rates because

- a) the Fed was buying more short-term than long-term bonds on the open market
- b) the Fed was selling more short-term than long-term bonds on the open market
- c) long-term inflation expectations were higher than short-term inflation expectations
- d) long-term inflation expectations were lower than short-term inflation expectations

25. "As actual inflation increased, workers and businesses began to incorporate expectations of higher and higher inflation into their behavior. The Phillips curve consequently" Complete this clipping.

- a) shifted up
- b) shifted down
- c) became flatter
- d) became steeper

26. "The U.S. price control program, which was adopted in the second half of 1971, partly suspended the market system, producing distortion and shortages while

suppressing inflation instead of resolving it." The inflation was suppressed rather than resolved because

- a) the permitted price increases were not set low enough
- b) the money supply growth rate was not lowered enough
- c) the penalties for violation of the controls were too light
- d) the market system was partly instead of fully suspended

27. "The Fed has always acknowledged openly that disinflation involved employment costs. A key message in its officials' speeches during disinflation was that the employment consequences would be reduced once wage and price setters realized that it was absolutely committed to lowering inflation." The rationale behind this key message is that

- a) disinflation takes time
- b) the Phillips curve is asymmetric
- c) it is impossible to avoid prolonged high unemployment during disinflation
- d) unemployment during disinflation is much lower if expectations of inflation fall quickly

28. "Stockman told the U.S. Chamber of Commerce that 'High interest rates, unacceptable levels of current unemployment, lost output, financial strains and rising bankruptcies in the economy are all unpleasant facts of life, but are all part of the cure, not the problem.'" The rationale for this is that recessions can cure

- a) inflation
- b) cyclical downturns
- b) c) real growth imbalances
- d) anomalous unemployment

29. "Some economists said the declining unemployment rate partly explains why the Fed has been pursuing a restrictive monetary policy for more than a year." This is because the Fed is worried that

- a) interest rates may start to rise
- b) it may lose control over money growth
- c) unemployment may fall below the NRU
- d) unemployment may not continue to fall

30. "Most estimates suggest that America's natural rate of unemployment is around 6 percent, only slightly higher than it was in the 1960s. Since the current jobless rate is 6.1 percent, this suggests that the Fed was right to push up interest rates this spring - and may even have acted a bit too late." The Fed was right to push up interest rates because it needs to

- a) avoid higher taxes
- b) head off possible inflation
- c) promote long-term growth
- d) prevent the economy from reaching the NRU

31. "On the other hand, there was a singular economic success in the past decade: A rampant inflation was curbed, albeit at the cost of _____, and Federal Reserve actions to keep the flow of money into the economy at moderate levels have kept the lid on since." The blank is best filled with

- a) high taxes
- b) big budget deficits
- c) high unemployment
- d) low real interest rates

32. "As well, the chairman of the Fed had come to represent what many liberals regard as a policy-induced recession." In this context a policy-induced recession is best described as a recession

- a) caused in error by policy
- b) created to influence policy
- c) caused deliberately by policy
- d) caused as an unexpected side-effect of a policy directed to achieving some other end

33. "By tying the pay of the governor of the central bank to his success in keeping inflation below two percent, New Zealand has succeeded in keeping inflation low. Now there are calls to tie the pay of the minister of employment to his success in keeping unemployment below two percent." This proposal is a

- a) good idea because there is no excuse for unemployment ever to be above two percent
- b) good idea because it will provide an incentive for the government to keep unemployment below two percent
- c) bad idea because governments should be allowed to undertake policy at their discretion
- d) bad idea because two percent unemployment is probably an unrealistically-low target

34. "The Bank of Canada's battle to cut inflation to 2.0 percent from 5.0 percent cost the Canadian economy \$105 billion in lost production, says a new study."

If Canada's full employment level of output is \$700 billion, what is its sacrifice ratio?

- a) 5 or less
- b) more than 5 but not more than 10
- c) more than 10 but not more than 15
- d) more than 15

35. Suppose the short-run Phillips curve is such that a two percentage point increase in inflation decreases unemployment by one percentage point. Suppose the economy is in equilibrium with a real growth rate of 2 percent and an unemployment rate of 7 percent and the central bank increases the rate of growth of the money supply from 5 percent to 8 percent. When the economy has reached its new equilibrium, the levels of inflation and unemployment will be

- a) 6% and 7%
- b) 6% and 5.5%
- c) 3% and 7%
- d) 3% and 5.5%

36. Suppose person A forms his inflation expectations as the average of this period's inflation and last period's inflation, whereas person B forms her expectations rationally (i.e., by using all information plus knowledge of how the macroeconomy operates). Suppose the economy is in equilibrium at its NRU and the Fed surreptitiously increases the money growth rate from 6 percent to 9 percent increasing inflation during the year from 4 percent to 6 percent and lowering unemployment slightly. At the end of this year it becomes clear what the Fed has done; at this point

A's and B's expected inflations are

- a) 5% and 6%
- b) 5% and 7%
- c) 6% and 6%
- d) 6% and 7%

Suppose the economy is at its natural rate of unemployment of 6% with a real output of \$900 billion, but policymakers plan to reduce inflation from 8 percent to 4 percent gradually over a period of six years by creating a recession.

37. If the sacrifice ratio is 3, relative to maintaining full employment, what is the cumulative loss in output this recession will entail?

- a) \$30b or less b) more than \$30b but less than \$60b
- c) more than \$60b but less than \$90b d) more than \$90b

38. If Okun's law says that an extra percentage point of unemployment above the natural rate corresponds to a drop in output of 2 percentage points, what unemployment rate will the economy be required to experience over these six years?

- a) 6% or less b) more than 6% but not more than 7%
- c) more than 7% but not more than 8% d) more than 8%

39. Wage/price controls allow us to

- a) control what is produced in the economy
- b) move more quickly down the long-run Phillips curve
- c) stop inflation without decreasing the rate at which money is growing
- d) deal with inflation without losing the efficiencies of the price system

40. An incomes policy is designed to

- a) increase everyone's real income b) redistribute income from the rich to the poor
- c) increase the actual income of the unemployed
- d) curb inflation without reducing aggregate demand

41. Rational expectations implies that

- a) the short run Phillips curve becomes vertical
- b) people no longer persistently over- or under-estimate inflation
- c) the short run trade-off of inflation versus unemployment disappears
- d) movements up the long-run Phillips curve are faster than movements down it

42. To be successful a wage-price control program

- a) must be introduced gradually b) must have high penalties for violators
- c) must allow the price mechanism to operate freely
- d) must be accompanied by a reduction in money supply growth

43. The short-run Phillips curve

- a) is a menu of policy choice b) shifts up when expected inflation increases
- c) graphs the natural rate of unemployment against inflation
- d) shows a trade-off between unemployment and accelerating inflation

44. The asymmetry of the short-run Phillips curve gives rise to what policy conclusion?

- a) Policy cannot decrease the unemployment level below the NRU
- b) Any policy to decrease unemployment rate below the NRU will accelerate inflation
- c) The cost of reducing inflation is greater than the benefit gained from raising inflation.
- d) The only effective policies lowering unemployment are policies reducing the NRU.

45. Which of the following best describes a policy moving the economy to the left along a short-run Phillips curve?

- a) a contractionary monetary policy designed to reduce inflation
- b) an expansionary monetary policy designed to reduce inflation
- c) an expansionary monetary policy designed to reduce unemployment
- d) a contractionary monetary policy designed to reduce unemployment

46. If we are at the natural rate of unemployment, an increase in aggregate demand will lower unemployment in the short run
- if workers perfectly anticipate inflation
 - regardless of workers' inflation estimates
 - if workers overestimate the consequent inflation
 - if workers underestimate the consequent inflation
47. If rapid inflation occurs in a relatively full employment economy, well-coordinated monetary and fiscal policies would involve a budget
- deficit and central bank increase in annual bond purchases
 - surplus and central bank increase in annual bond purchases
 - deficit and central bank reduction in annual bond purchases
 - surplus and central bank reduction in annual bond purchases
48. "The employment numbers were a bit of a shocker, but the market isn't that concerned about inflation because of the potential for Asian weakness to slow the U.S. economy." This is best interpreted as
- unemployment rose and U.S. exports to Asia should rise
 - unemployment rose and U.S. exports to Asia should fall
 - unemployment fell and U.S. exports to Asia should rise
 - unemployment fell and U.S. exports to Asia should fall
49. "The snag is that governments, like voters, are naturally more interested in short-term than long-term growth. Inflationary policies can spur growth for a time, which is why politicians have often found them so tempting. This is the best argument for making central banks" This is best completed with
- responsible for fiscal policy
 - subservient to governments
 - independent of governments
 - focus policy on unemployment
50. "Undoubtedly, the amazing drop in the unemployment rate adds to pressure on Mr. Greenspan, the chairman of the Fed, to" This is best completed with
- print more money
 - fix the interest rate
 - raise the interest rate
 - lower the interest rate
51. "For example, the upward shift in the Phillips curve that occurred in the early 1970s followed several years in which policymakers allowed money growth to accelerate in an (ultimately vain) attempt to keep _____. The downward shift in the mid 1980s occurred only after policymakers demonstrated that they were willing to _____ to move the inflation rate lower." The blanks are best filled with
- interest rates low; reduce the NRU
 - real growth low; cut money growth
 - unemployment low; tolerate high unemployment
 - the economy at the NRU; impose wage-price controls
52. "A striking feature of the economy's performance over the past four years is how well behaved inflation has been, despite tight labor markets. This experience has led some analysts to declare the Phillips curve dead! One response is to argue that the Phillips curve is not dead, merely that the" This is best completed with

- a) short-run Phillips curve has shifted down b) short-run Phillips curve has shifted up
 c) long-run Phillips curve has shifted left d) long-run Phillips curve has shifted right

53. "American businesses created 262,000 new jobs last month, and unemployment fell to an astoundingly low 4.3%, a level not seen since Feb. 1970. And still no sign of inflation. All this good news is befuddling many economists." This news befuddles economists because it is inconsistent with

- a) the monetarist rule b) fiscal policy goals
 c) a traditional market economy d) the usual Phillips curve analysis

54. "Despite the inflationary pressures that remained when he took office, President Jimmy Carter was reluctant to mount a strong anti-inflation program lest it interfere with his commitment to" This is best completed with

- a) lower taxes b) productivity growth
 c) lower unemployment d) higher government spending

55. "The Federal Reserve Bank Act of 1978 requires the Fed to pursue full employment as well as low inflation, but Mr. Greenspan has said that he favors legislation to make price stability the Fed's sole objective." The main reason the chairman of the Fed prefers to have price stability as his sole objective is because

- a) he doesn't care about unemployment
 b) inflation is the easiest goal for the Fed to achieve
 c) inflation is the goal over which the Fed has the greatest influence
 d) pursuing other goals could prevent the Fed from achieving the inflation goal

56. "But monetary policy cannot be tuned to real economic variables like growth or employment, not only because policy takes effect with long and uncertain lags, but because any commitment to real growth targets simply invites workers and business to increase wages and prices at will, in the knowledge that the central bank will ratify their demands via the money supply." Ratifying demands via the money supply means that money growth will be

- a) fixed at a low, steady rate b) whatever is needed to prevent inflation
 c) whatever is needed to maintain full employment
 d) whatever is needed to maintain a desired interest rate

57. "The realistic alternative to high interest rates is not lower interest rates (except temporarily) but even higher interest rates and a monetary inflation that would make our heads spin." Which of the following statements seems out of place in this context?

- a) the Fed can raise interest rates by selling bonds and the lower them by buying bonds
 b) targeting on the interest rate is a dangerous monetary policy in inflationary environments
 c) the Fed could become caught up in a vicious cycle of increasing the money supply to lower the interest rate leading to higher inflationary expectations and higher interest rates
 d) lowering interest rates in an inflationary environment requires lowering inflation which requires a restrictive monetary policy producing initially a higher interest rate

58. "We at the Fed are frequently pressed by people to do things that would involve giving up control over money creation without any apparent recognition on their part that

that is what they are asking. We, of course, have to refuse." Which of the following is not an example of such a request?

- a) adopt the monetarist rule
- b) produce an unemployment rate lower than the NRU.
- c) finance government deficits to avoid the higher interest rates they produce.
- d) effect an immediate lowering of the interest rate in an inflationary environment

59. "There is little doubt that the key reason for this slide toward ever more inflation was an effort by public policy in most countries to achieve and maintain more output and employment from their economies than was consistent with price stability." Which of the following is not an explanation for this?

- a) the government was increasing taxes higher and higher
- b) monetary policies were targeting unemployment instead of inflation
- c) monetary authorities increased their money supplies at too high a rate
- d) lowering unemployment below the NRU requires accelerating inflation

60. "The message from the central bank to the private sector is: Do not give in to inflationary psychology; Do not assume that you can easily accommodate cost pressures; and Do not expect monetary accommodation of accelerating energy price increases." The central bank must have announced that it will be targeting on

- a) an interest rate
- b) an energy price
- c) full employment
- d) a money growth rate

61. "In the longer term, however, things will be different. It is worth recalling that seigniorage is no longer being exercised by all those seigneurs - emperors, kings and imperial governments - who once possessed it. The reason is simple: seigniorage is such a tempting privilege that it always ends up being abused." The outcome of abusing seigniorage is

- a) high inflation
- b) high interest rates
- c) high unemployment
- d) both a) and b) above

62. "As the election draws nearer, the prospect of an economy awash in money becomes likely. It is therefore reassuring that the central bank remains vigilant about the dangers of inflation." To be vigilant about inflation the central bank should

- a) fix the interest rate
- b) maintain full employment
- c) prevent the money growth rate from rising
- d) follow faithfully instructions from its political masters

63. "There's nothing wrong with any level of interest rates produced by the natural forces in the economy. But artificially lowered rates are dangerous because they are produced by artificial increases in the money supply. And the extra money sluicing around in the system at a time when production is close to capacity is more likely to go into higher prices than anywhere else." A Fed effort to lower the interest rate by increasing money growth when at full employment will end up

- a) increasing taxes
- b) increasing bond prices
- c) decreasing unemployment
- d) increasing the interest rate

64. "I wouldn't say that a lower dollar is inflationary. A lower dollar means you're paying more for your imports. In other words, it adds to your cost of living, and it can become inflationary if" Complete this clipping.

- a) it causes real wages to fall
- b) it moves us below full employment

- c) taxes do not fall to offset this higher cost
- d) this higher cost is accommodated by the central bank

"Governments increase the money supply too rapidly because it enables them to finance an expanding government sector without increasing taxes or borrowing from the economy's savings."

65. This means of financing is referred to as
- a) seigniorage
 - b) printing money
 - c) selling bonds to the central bank
 - d) all of the above

66. Borrowing from the economy's savings means
- a) printing money
 - b) lowering taxes
 - c) lowering interest rates
 - d) selling bonds to the public

"What is important for inflationary expectations is how the bank has responded to such shocks in the past. A central bank which has shown it will not accommodate inflationary shocks will find it much easier to maintain a stable inflation rate - whatever its level - than one with a reputation for accommodation."

67. 'Accommodate inflationary shocks' means that the central bank will
- a) keep the money supply growth constant
 - b) increase the money supply to finance government spending
 - c) increase the money supply to match any decreases in money demand
 - d) increase the money supply to prevent inflationary shocks from decreasing unemployment

68. A central bank with a reputation for not accommodating inflationary shocks will find it easier to maintain a stable inflation rate because
- a) inflation expectations will remain constant
 - b) its policies for preventing unemployment will be more credible
 - c) it will be able to buy and sell bonds without affecting their price
 - d) its open market operations to fix the interest rate will be more effective

69. "A second flaw in economic policy lay in the contradiction between price stability and the pledge to maintain full employment. Why? Because firms and workers took the full-employment pledge seriously." Explain how this flaw ruined economic policy.
- a) fiscal policy could not be financed
 - b) firms and workers became unproductive
 - c) monetary policy was automatically restrictive
 - d) wages and prices could be increased without fear of losing jobs or sales

70. "According to one theory, the U.S. recession-inflation debate boils down to whether the natural unemployment rate is higher or lower than the current 5.7 percent level." If the NRU is higher than the current 5.7 percent, then monetary policy should
- a) tighten
 - b) lower interest rates
 - c) fix interest rates
 - d) expand the money supply

71. "The Federal Reserve must be conscious of the limits of its capabilities. We can try to provide a backdrop for stable, sustainable growth, but we cannot iron out every

fluctuation, and attempts to do so could be counterproductive,' Alan Greenspan, the Fed chairman, said." The Fed would provide a backdrop for stable, sustainable growth by

- a) preventing inflation
- b) fine-tuning monetary policy
- c) keeping the interest rate fixed
- d) reacting quickly to offset monetary shocks

72. "This brings us back to the fears of higher interest rates before the market break. These fears are still potent, especially if investors see through the temporary reduction in interest rates made possible by stepping up the rate of creation of the money supply." Why would the reduction be only temporary?

- a) bond prices will eventually move higher
- b) permanently-lower interest rates are impossible
- c) the Fed will reverse its policy once it sees its mistake
- d) inflation expectations would rise, increasing the nominal interest rate

73. "Many politicians say they favor low interest rates but believe in their hearts that higher rates are necessary to control" Complete this clipping.

- a) inflation
- b) budget deficits
- c) rising unemployment
- d) upward-creeping taxes

74. "The governor of the central bank responded by saying that there is nothing in the experience of any country which would suggest that monetary policy can produce sustainable decreases in unemployment beyond those that can be achieved by maintaining stable prices." This is because such decreases in unemployment

- a) increase real wages too much
- b) require unacceptably high taxes
- c) are obtained by fooling workers
- d) are obtained by shifting the long-run Phillips curve

75. "The Japanese government made the biggest blunder. Between 1985 and 1989, the Bank of Japan (Japan's Fed) kept interest rates too low." This was a mistake because it

- a) cut growth
- b) accelerated inflation
- c) created unemployment
- d) created budget deficits

76. "The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth would soon be counterproductive. The implications for interest rates would in the end be perverse." Interest rate movements would in the end be perverse because

- a) lower bond prices could not be sustained by this policy
- b) unemployment would force the Fed to change its policy
- c) budget deficits would force the Fed to change its policy
- d) inflation expectations would raise the nominal interest rate

77. A large annual increase in the federal debt can lead to inflationary pressure if

- a) the total debt exceeds 50% of GDP
- b) business is so concerned about the size of the debt that investment spending is cut back
- c) the government attempts to liquidate the debt rapidly by increasing tax rates and cutting back government spending
- d) the debt leads the central bank to maintain low interest rates when a more restrictive monetary policy is appropriate

78. By targeting on the nominal interest rate, the central bank
- a) is following the monetarist rule
 - b) controls the real rate of interest
 - c) loses control over the money supply
 - d) reduces uncertainty in the business community
79. "Business productivity in the last quarter grew at its fastest pace in six years, offering another explanation for how the strong U.S. economy has kept inflation at bay." Higher productivity growth helps keep inflation at bay by all of the following except
- a) increasing aggregate supply
 - b) decreasing the demand for money
 - c) lowering the natural rate of unemployment
 - d) allowing wage increases without price increases
80. "The robust increase of production has been using up our nation's spare labor resources, suggesting that recent strong growth in spending cannot continue without a pickup in inflation unless" The least reasonable way to complete this clipping is
- a) investment increases
 - b) productivity growth increases
 - c) the natural rate of unemployment falls
 - d) there is a large increase in encouraged workers
81. "The truth is that recessions are almost always policy-induced. They are the product not of time or chance but of government action." Policy-induced recessions are created to
- a) fight inflation
 - b) enhance growth
 - c) avoid unemployment
 - d) reduce the natural rate of unemployment
82. Years of high growth generally ____ inflation, which in turn prompts the Federal Reserve to ____ interest rates, a step that runs the risk of triggering _____. The blanks are best filled with
- a) fuel; raise; a recession
 - b) reduce; cut; a recession
 - c) fuel; lower; inflation
 - d) reduce; raise; inflation
83. "The Federal Reserve chairman told congress that 'the Fed is unlikely to raise interest rates in the near future.' He also stated that 'a strong signal of inflation pressures has not yet clearly emerged.'" These statements are
- a) inconsistent because inflation is improperly measured
 - b) consistent because the Fed is following the monetarist rule
 - c) consistent because higher interest rates are only needed to fight inflation
 - d) inconsistent because higher inflation will automatically cause nominal interest rates to rise
84. "Fans of the new-economy theory say U.S. businesses have become so efficient, and the world so open and competitive, that workers deserve _____ and businesses can't get away with _____. The fluke school argues that temporary factors- low energy prices, a strong dollar, and weak demand in Asia - will eventually go away, causing _____." The blanks are best filled with
- a) wage freezes; layoffs; inflation
 - b) wage increases; raising prices; inflation
 - c) to be unemployed; layoffs; unemployment
 - d) wage decreases; raising prices; unemployment

85. "Higher interest rates must boost the cost of all sorts of things for business. How can higher interest rates be anti-inflationary?" Higher interest rates are anti-inflationary because they

- a) lower the price of bonds
- b) dampen aggregate demand
- c) are caused by the premium for inflation in nominal interest rates
- d) encourage imports which increases supply of goods and services

86. "Even some Fed critics are reluctant to change its structure. Mr. Feldstein warns that "substituting political judgements for economic judgements brings a built-in bias toward _____."

The blank is most appropriately filled with

- a) the rich
- b) inflation
- c) high taxes
- d) unemployment

87. "It is economists who repeat their own mistakes, because their calculations are looking at the world through a rearview mirror. Business leaders describe the change in two words: productivity and competition. Both, they say, wring out inflation and enable them to increase production and hire more people without raising wages, and without putting pressure on their own prices." This economists mistake during the late 1990s is economists belief that

- a) fiscal policy sets a multiplier process in motion
- b) inflation will increase if the money growth rate increases
- c) if unemployment falls below the NRU inflation will increase
- d) increases in our standard of living are caused by productivity increases

88. "Are too many Americans at work these days for the economy's own good? Absolutely, says Martin Feldstein, former head of the Council of Economic Advisors. By his calculations, unemployment has already fallen way below the level he believes is sure to trigger _____" The blank is best filled by

- a) a recession
- b) rising inflation
- c) rising tax rates
- d) a budget deficit

89. "George W. Bush's \$168 billion tax rebate plan of February of 2008 was designed to stimulate the U.S. economy, but it didn't work, and so instead" This statement is best completed with

- a) taxes were raised back to their original level
- b) government spending was increased
- c) a stimulating monetary policy was adopted
- d) both b) and c)

90. "United States inflation expectations are quite well anchored, giving the Federal Reserve Board breathing room for further possible rate cuts." The rationale behind this statement is that in this circumstance rate cuts will

- a) not affect inflation expectations and will lower unemployment
- b) create higher inflation expectations and higher unemployment
- c) lower inflation expectations and lower unemployment
- d) raise inflation expectations and lower unemployment

91. "This month's slight uptick in the Australian unemployment rate to 4.5 percent shouldn't be taken too literally. It's probably just a blip. But it's a timely reminder that

unemployment shouldn't fall much lower. If it does, it won't be a good sign." We would not want unemployment to fall much lower because

- a) resources will be misallocated
- b) creative destruction will happen
- c) inflation will develop
- d) tax receipts will fall

92. "Policy makers are performing a balancing act, trying to bring inflation down without" This statement is best completed with

- a) raising taxes
- b) creating a budget deficit
- c) creating a recession
- d) creating deflation

93. "Unless the economy slows more than the Fed now expects, the central bank might need to sooner rather than later to control inflation." The missing part of this statement is best filled with

- a) increase the money supply
- b) increase interest rates
- c) increase taxes
- d) impose price controls

94. "A Bank of Canada report suggested that wage inflation pressures are increasing, further reducing the odds that the Bank of Canada will follow the lead of the U.S. Federal Reserve and start" This statement is best completed with

- a) reducing spending
- b) increasing taxes
- c) increasing interest rates
- d) reducing interest rates

95. "You can't be the head of the world's most powerful central bank and appear wishy-washy on interest rate policy, even if you really don't know where that policy is going. You have to project confidence and certainty or the market will get you by if it perceives you are behind the curve on inflation." The missing part of this clipping is best filled by

- a) raising expectations of inflation
- b) reducing spending
- c) reducing interest rates
- d) increasing the money supply

96. "The main reason the U.S. experienced very little inflation in the late 90s, despite full employment and low interest rates, was because" This clipping is best completed by

- a) of good fiscal policy
- b) of a tight monetary policy
- c) of high productivity growth
- d) weak labor unions

97. "Canada's unemployment rate fell to its lowest level in 30 years in October, fuelling fears of and adding to the pressure for from the Bank of Canada." The missing parts of this clipping are best filled by

- a) inflation; higher money growth
- b) inflation; higher interest rates
- c) a recession; higher money growth
- d) a recession; higher interest rates

98. "Federal Reserve chairman Ben Bernanke said inflation should ease later this year and in 2009, while warning that policy makers will act if price increases don't slow over the 'medium term'" What action would the Fed take if price increases did not slow?

- a) decrease the required reserve ratio
- b) increase interest rates
- c) increase the money supply
- d) raise taxes

99. "Softer commodity prices, a firmer greenback, and weak demand will likely drive inflation lower in the months ahead. This opens the door a crack for renewed Fed easing if the economy takes a turn for the worse." What has inflation got to do with this? Lower inflation means that the Fed can

- a) stimulate without provoking inflation
- b) attack recession by increasing inflation
- c) decrease the money supply without harming the economy
- d) lower real interest rates by raising nominal interest rates

100. "U.S. consumer price inflation is receding, a development that gives the Federal Reserve additional leeway to _____ in the weeks ahead should it be needed, a likely scenario." The blank is best filled by

- a) lower taxes
- b) decrease the budget deficit
- c) lower interest rates
- d) decrease the money supply

102. "Economic growth is supposed to be a good thing, right? Not always. If it gets too strong" The best way of completing this statement is

- a) income maldistribution occurs
- b) inflation is created
- c) unemployment increases
- d) a budget deficit develops

103. "Just 21,000 new jobs were created in February, compared with forecasts for 125,000, marking another month in which economic growth failed to translate into strong hiring. _____ allows companies to lift output without boosting payrolls, leaving slack in the economy to keep wages in check and allowing the Fed to view inflation as a distant risk despite powerful growth." The blank is best filled with

- a) productivity growth
- b) lower interest rates
- c) higher taxes

d) unemployment

104. "Canada's job creation machine churned out 34,300 positions in October, far surpassing expectations, and increasing the odds that the Bank of Canada will The unemployment rate held steady at 7.1 per cent." Fill in the blank, and explain why the unemployment rate did not fall with so many new jobs.

- a) raise interest rates; the participation rate rose
- b) raise interest rates; the participation rate fell
- c) lower interest rates; the participation rate rose
- d) lower interest rates; the participation rate fell

105. "In October 1979, Mr. Volker launched one of modern history's riskiest inflation fights. With consumer prices surging 14% and the bond yield at 15% he dramatically" This clipping is best completed with

- a) raised taxes
- b) lowered taxes
- c) increased the money growth rate
- d) decreased the money growth rate

106. "Central banking is as much about winning the trust of markets as adjusting interest rates." Explain the logic of this statement. If the markets trust the central bank to do the right thing in the long term, then short-term actions by the central bank will not

- a) create instability
- b) affect inflation expectations
- c) disrupt markets
- d) all of the above

Answers: 1b 2b 3d 4a 5d 6d 7d 8d 9a 10b 11b 12b 13b 14b 15c 16d 17d 18d 19d 20c 21d 22d 23c 24c 25a 26b 27d 28a 29c 30b 31c 32c 33d 34a 35a 36b 37d 38b 39b 40d 41b 42d 43b 44c 45c 46d 47d 48d 49c 50c 51c 52c 53d 54c 55d 56c 57a 58a 59a 60d 61d 62c 63d 64d 65d 66d 67d 68a 69d 70a 71a 72d 73a 74c 75b 76d 77d 78c 79b 80a 81a 82a 83c 84b 85b 86b 87c 88b 89d 90a 91c 92c 93b 94d 95a 96c 97b 98b 99a 100c 101b 103a 104a 105d 106d

Chapter 13: Balance of Payments

1. "While some in the U.S. put the trade deficit down to failing U.S. competitiveness, or protectionist policies abroad, he claims its genesis lies in the budget deficit, and the consequent shortfall in U.S. domestic saving relative to investment."

Explain how the U.S. budget deficit could be responsible for the U.S. trade deficit. The U.S. budget deficit raises interest rates which

- a) increases capital inflows which bids up the value of the U.S. dollar which lowers exports and raises imports

- b) increases capital inflows which bids down the value of the U.S. dollar which lowers exports and raises imports
- c) decreases capital inflows which bids up the value of the U.S. dollar which lowers exports and raises imports
- d) decreases capital inflows which bids down the value of the U.S. dollar which lowers exports and raises imports

2. "Looking at the data, some people might say the balance of payments has 'improved' radically, from a \$7 billion current account deficit three years ago to surpluses of \$4 billion and \$2 billion in the last two years. It is this ongoing current account surplus which led the optimists to predict that the dollar should appreciate." Appreciation of the dollar would require a flexible exchange rate and a surplus in the

- a) capital account
- b) current account
- c) balance of trade
- d) balance of payments

"The link between the current and capital accounts is often misunderstood. Leaving aside the relatively small influence of central-bank intervention in foreign exchange markets, any deficit or surplus on capital account must be matched by an equal and opposite surplus or deficit on current account. It follows that, as long as the U.S. is to be a capital importer, it must have"

3. Central-bank intervention refers to Fed

- a) prohibition of capital outflows
- b) open market bond sales or purchases
- c) taxation of foreign exchange transactions
- d) sales or purchases of U.S. dollars on the foreign exchange market

4. This clipping is best completed with

- a) a balance of trade deficit
- b) a current account deficit
- c) a balance of payments deficit
- d) a balance of payments surplus

"While some in the U.S. put the trade deficit down to failing U.S. competitiveness or protectionist policies abroad, some economists claim that its genesis lies in the budget deficit, and the consequent shortfall in U.S. domestic savings relative to investment."

5. A budget deficit leads to a shortfall in domestic savings relative to investment because

- a) saving falls because the interest rate falls
- b) savers buy government bonds instead of private bonds
- c) saving falls because of concern about the size of the deficit
- d) investment falls because of concern about the size of the deficit

6. A budget deficit creates a trade deficit because a budget deficit causes the interest rate to

- a) rise, increasing capital inflows which bids up the value of the dollar
- b) rise, decreasing capital inflows which bids down the value of the dollar
- c) fall, increasing capital inflows which bids up the value of the dollar
- d) fall, decreasing capital inflows which bids down the value of the dollar

7. A strong dollar is a mixed blessing. It _____ the price of imports, thus _____ inflation, and it makes trips to foreign countries _____ for Americans. But it makes our exports _____. The blanks are best filled with.

- a) lowers; lowering; expensive; cheap b) raises; increasing; expensive; cheap
c) lowers; lowering; cheap; expensive d) raises; increasing; cheap; expensive

8. "Analysts have warned for months that the trade gap would widen once consumer demand picks up." The trade gap will become a bigger

- a) deficit because of lower exports b) deficit because of higher imports
c) surplus because of a higher demand for money
d) surplus because of increased domestic economic activity

9. "He argued that one byproduct of the ballooning federal deficits of the early 1980s was a large rise in _____ and a concomitant loss of American competitiveness on world markets. The resulting rise in the U.S. _____ was the counterpart of the _____ that kept domestic investment from falling as much as did national saving." Fill in the blanks.

- a) the interest rate; dollar; increased capital outflows
b) the exchange rate; capital account surplus; falling U.S. dollar
c) the interest rate; current account surplus; rise in the U.S. dollar
d) the exchange rate; current account deficit; increased capital inflows

10. "Also, through the mid-1980s the policies followed by the Reagan administration, particularly tight monetary policy combined with large government deficits, made the value of the dollar very high." These policies increased the value of the dollar because

- a) they raised interest rates which decreased imports
b) they raised interest rates which increased capital inflows
c) they lowered interest rates which increased exports
d) they lowered interest rates which increased capital inflows

11. "He says an overvalued dollar would be just another blow to an already fragile economy." An overvalued dollar would be a blow to the economy because it would

- a) decrease exports b) encourage capital inflows
c) increase the domestic money supply
d) increase demand for import-competing goods and services

12. "Now it's the once-mighty German mark's turn to come under attack. Following Thursday's cuts in the Bundesbank's trend-setting interest rates, the mark slipped further against the pound and the US dollar." The mark is falling because the cut in the German interest rate has

- a) decreased capital inflows, decreasing demand for the mark
b) increased capital inflows, decreasing demand for the mark
c) decreased capital inflows, increasing demand for the mark
d) increased capital inflows, increasing demand for the mark

13. "Normally, a weak trade figure would send the dollar into a tailspin. But market players could be judging that signs indicate a still-strong U.S. economy, implying continued upward pressure on interest rates. Currency traders may be working on the

expectation that the Fed is going to have to push up short-term rates to choke off some domestic demand." The tailspin is being avoided here because

- a) the balance of trade deficit is being offset by a capital account surplus
- b) the balance of trade deficit is being offset by a current account surplus
- c) the balance of trade surplus is being offset by a capital account deficit
- d) the balance of trade surplus is being offset by a current account deficit

"Historically, the winners on the foreign exchange market are the big banks. Citicorp, for example, typically earns about \$600 million a year from its currency trading operation. The losers? Central banks, for one. Recently the Bank of England bought pounds to _____ but the pound kept _____ and huge losses developed."

14. The blanks are best filled with

- a) prevent the pound from falling; falling
- b) prevent the pound from falling; rising
- c) prevent the pound from rising; falling
- d) prevent the pound from rising; rising

15. Citicorp would make money at the expense of the Bank of England by

- a) selling pounds for future delivery
- b) selling pounds for immediate delivery
- c) buying pounds for future delivery
- d) buying pounds for immediate delivery

16. "The survey found that 28 percent of U.S. dollar trading in North America is in the mark, 23 percent in the yen, 13 percent in the British pound and 9 percent in the Swiss franc. Rounding out the list of major trading currencies at 3 percent to 7 percent each, are the Canadian and Australian dollars and the French franc." The U.S. trades more with Canada than with any other country. The Canadian dollar is low in this survey because

- a) although the volume of trade with Canada is high, its value is low
- b) exports to and imports from Canada come close to canceling each other
- c) most dollar buying and selling doesn't have anything to do with trade
- d) the balance of trade with Canada is almost exactly offset by capital flows

17. "The statistical evidence is that there is a strong correlation between increases in current account surpluses and declines in the value of the dollar. This is just the opposite of the conventional wisdom." This evidence can best be explained by

- a) declines in the value of the dollar causing increases in exports and decreases in imports
- b) declines in the value of the dollar causing decreases in exports and increases in imports
- c) increases in current account surpluses causing demand for the dollar to exceed its supply
- d) increases in current account surpluses causing supply of the dollar to exceed its demand

18. "With our unemployment rate so close to the natural rate, there is no room for interest rate cuts, but if unemployment should start to rise, Alan Blinder, Vice-Chairman of the Federal Reserve Board, may want an early cut in rates. If he succeeds, bond yields and the dollar could both be in for a mauling." The dollar would fall because

- a) exports would fall
- b) imports would fall
- c) capital inflows would fall
- d) capital outflows would fall

19. "The large and persistent trade deficit has provoked concern among the general public and in the financial markets. The deficit resulted from the high-dollar policies of the Reagan administration in the early 1980s." The high-dollar policy resulted from

- a) national pride
- b) high interest rates
- c) high money growth
- d) import restrictions which created a balance of trade surplus

20. "These reports suggest that the United States is heading for a recession. Activity on the futures market for the U.S. dollar suggests that the market thinks the dollar will soon depreciate." The dollar is likely to depreciate because

- a) the recession will decrease imports
- b) the demand for the dollar currently exceeds its supply
- c) the recession will prompt the Fed to lower interest rates
- d) the recession will prompt the government to increase its spending

21. "They conclude that in many Canadian export sectors the devaluation of the Canadian dollar will not greatly aid sales. Progress will be slow, they stated, because any U.S. slowdown would overshadow the price effects of the devalued dollar." Canadian export sales will not jump because

- a) American imports fall during a recession
- b) American exports will dominate Canadian exports
- c) an American balance of payments deficit will overpower the Canadian exports
- d) the price of Canadian exports will increase by more than the dollar devaluation

22. "The stronger yen is the best single thing that could have happened to the trade deficit,' a senior Administration official said last week." The stronger yen will

- a) increase U.S. exports
- b) increase U.S. imports
- c) increase U.S. capital inflows
- d) decrease U.S. capital inflows

23. "The U.S. trade deficit is not permanent. When the U.S. ceases to be a major importer of capital....." Complete this clipping.

- a) the demand for the dollar will fall causing the exchange rate to fall causing exports to rise and imports to fall
- b) the demand for the dollar will fall causing the exchange rate to rise causing exports to fall and imports to rise
- c) the demand for the dollar will rise causing the exchange rate to rise causing exports to fall and imports to rise
- d) the demand for the dollar will rise causing the exchange rate to fall causing exports to increase and imports to decrease

"The April U.S. trade deficit narrowed by 41 percent from March. Investors greeted the news with gusto, driving bonds more than a point higher in minutes. It was a classic suckers' rally. Traders soon realized the trade improvement was because of a 23 percent climb in exports. Fears of surging demand in an environment of near-full employment and capacity constraints were rekindled. Prices turned on a dime and wound up nearly two points off their highs by the end of the day."

24. The narrowing of the trade deficit caused the price of bonds to rise because

- a) the balance of payments deficit should narrow, pushing up interest rates

- b) the current account should move towards deficit, causing the interest rate to rise
- c) fewer capital inflows are needed for international balance so the interest rate should fall
- d) exports are up and imports down, so that domestic prosperity is assured, increasing the demand for domestic bonds

25. Bond prices fell because higher exports

- a) cause higher imports, decreasing economic activity, causing bond sales
- b) means higher demand for the U.S. dollar, causing people to sell bonds to get dollars
- c) create inflationary pressures, increasing inflation expectations and thus increasing the interest rate
- d) create inflationary pressures, increasing inflation expectations and thus decreasing the interest rate

26. "Everyone loves the U.S. dollar these days and the fall in the current account deficit just added to its popularity." A fall in the current account deficit makes the dollar more popular because

- a) it signals that the interest rate is about to fall, attracting capital inflows
- b) other things equal, smaller current account deficits mean lower imports
- c) other things equal, it means a balance of payments surplus which bids up the value of the dollar
- d) the smaller current account deficit means the value of the dollar will continue to fall, albeit more slowly, increasing exports

27. "The report concludes that the recent strength in U.S. investment has been financed by domestic investors redirecting funds from foreign capital markets to U.S. capital markets. Thus, increased demand for U.S. dollars isn't the reason for the strength of the U.S. dollar, but rather a decreased U.S. demand for foreign currencies." U.S. investors redirected their funds because of

- a) an appeal to patriotism
- b) a current account surplus
- c) a rise in the U.S. interest rate
- d) a balance of payments surplus

28. "If domestic savings increases and domestic investment decreases, it is possible that a budget deficit may not lead to a deficit on current account." This could happen because under these circumstances

- a) tax receipts would increase
- b) the budget deficit would disappear
- c) the interest rate would fall, creating a balance of payments deficit
- d) the interest rate would rise, causing a balance of payments surplus

29. "These politicians talk as though they expect a Third World nation to be able to attract large inflows of capital and at the same time have large current account surpluses." If this country is to have equilibrium in its international sector this is

- a) possible if imports are low enough
- b) possible if exports are high enough
- c) possible if interest rates are high enough
- d) impossible because a surplus on the capital account implies a deficit on the current account

30. "The two-year-old recession appears to have deepened in the past two months, paving the way for _____ in interest rates and a steady _____ of the dollar in coming months, economists say." The blanks are best filled in with
- a) increases; appreciation
 - b) increases; depreciation
 - c) decreases; appreciation
 - d) decreases; depreciation
31. "Bonds were at the mercy of the dollar this week as a mid-week currency slump sent" Complete this clipping.
- a) interest rates higher as the Fed protected the dollar
 - b) interest rates lower as the Fed protected the dollar
 - c) bond prices higher as the Fed bought dollars on the foreign exchange market
 - d) bond prices lower as the Fed sold dollars on the foreign exchange market
32. "One way to alleviate inflationary pressure is to engineer an upward valuation of your currency against that of your major trading partners. A higher dollar means that imports are cheaper and prices should move lower." A rise in the dollar could be engineered by
- a) taxing exports
 - b) eliminating the budget deficit
 - c) having the Fed raise the real interest rate
 - d) having the Fed sell dollars on the foreign exchange market
33. "Nevertheless the finance minister has taken a pre-emptive strike in recent weeks against any pressure on his currency by cutting government spending to slow domestic consumption. That should reduce the trade deficit, but will also slow the economy." The trade deficit will be reduced because falling consumption means
- a) rising imports
 - b) falling imports
 - c) rising interest rates which increases capital inflows
 - d) falling interest rates which decreases capital inflows
34. "The dilemma facing the Fed is whether to _____ the discount rate charged to commercial banks to rejuvenate the stalled economy and risk _____ dollar." The blanks are best filled with
- a) lower; lowering
 - b) lower; raising
 - c) raise; lowering
 - d) raise; raising
35. "Economists who a week ago were talking about economic sluggishness now predict a strong recovery that, coupled with an expansive fiscal package, will _____ the dollar, hurt T-bills and drive market yields _____." Assuming no inflation concerns, the blanks are best filled with
- a) raise; higher
 - b) raise; lower
 - c) lower; higher
 - d) lower; lower
36. "Economists and important figures in the U.S. government have been debating whether it is government spending deficits, restrictive monetary policy, capital inflows, or anticipated inflation that is the real culprit for interest-rate increases in the U.S." Which of these could definitely not have caused high interest rates?
- a) capital inflows
 - b) anticipated inflation
 - c) restrictive monetary policy
 - d) government spending deficits

37. "The central bank isn't ready to lay down its main weapon - high interest rates - in the fight against inflation despite signs that prices have stabilized and that exporters are being hurt by this policy." Exporters are hurt because

- a) foreigners buy our bonds instead of our exports
- b) high interest rates attract capital inflows which bids up the exchange rate
- c) a high interest rate policy requires open market bond sales which reduces financing for exports
- d) high interest rates directly decrease all forms of aggregate demand for goods and services, including export demand

38. "Because Canadian inflation will continue to accelerate while inflation in the U.S. starts to decline, the Canadian dollar will probably _____ this year. This will force the Bank of Canada to _____ interest rates." The blanks are best filled with

- a) rise; increase b) rise; decrease c) fall; increase d) fall; decrease

39. Suppose a U.S. Toyota dealer imports 100 cars worth \$10,000 each and the Japanese manufacturer buys a U.S. bond with the \$1 million proceeds. Then the U.S. current account moves

- a) toward deficit and the balance of payments is unaffected
- b) toward surplus and balance of payments moves toward surplus
- c) toward deficit and balance of payments moves toward deficit
- d) toward deficit and the balance of payments moves toward surplus

40. If the exchange rate is 6 francs per dollar and 1.5 marks per dollar, what should be the exchange rate between francs and marks?

- a) 4 marks per franc b) 9 marks per franc c) 4 francs per mark d) 9 francs per mark

41. Suppose the central bank has intervened in the foreign exchange market to fix the exchange rate by selling \$4 billion. If the current account deficit is \$10 billion, the capital account balance is a surplus of

- a) \$4b b) \$6b c) \$10b d) \$14b

42. Suppose for a cost of \$100,000 the U.S. can produce 20 computers or 250 snowboards and for the same cost France can produce 15 computers or 200 snowboards. Then the U.S. has a comparative advantage in the production of

- a) computers b) snowboards
- c) both computers and snowboards d) neither computers nor snowboards.

43. "A trade deficit, he said, is not an indication that a country has low productivity or low-quality products. It is an indication that the domestic investment rate is high relative to the rate of _____." The blank is best filled with

- a) taxation b) interest c) inflation d) national saving

44. "At the moment, the market for the U.S. dollar is completely ignoring things like record U.S. trade deficits and the widening current account deficit. It also seems not to be afraid of the possibility of Federal Reserve rate _____. Instead, speculators appear to be counting on fiscal and monetary _____ in Japan."

The blanks are best filled in with

- a) increases; tightening b) increases; easing
c) decreases; tightening d) decreases; easing

45. "The Fed has shared in all of the Clinton administration's interventions so far. Through last June, the most recent period for which Fed disclosures are available, its biggest single intervention came on June 24, 1994, spending yen and marks to buy \$1.56 billion when the dollar ____ to 101 yen for the first time. That failed to stem the ____." The blanks are best filled with
a) fell; rise b) fell; fall c) rose; rise d) rose: fall

46. "Traders said the dollar will probably ____ if non-farm payrolls rose in August by anything less than 110,000, but if the gain was between 140,000 and 200,000 traders might expect a mild reaction. If the figure comes in above 200,000, it may reassure the market that the Fed won't need to cut rates." From the information available, if nonfarm payrolls rose by less than 110,000 we would expect
a) the dollar and bond prices to fall b) the dollar and bond prices to rise
c) the dollar to fall and bond prices to rise d) the dollar to rise and bond prices to fall

47. "During the past two years, the Clinton Treasury, which calls the shots on intervention in consultation with the Federal Reserve, has bought dollars on only 18 days. Through June, it had spent \$12.5 billion. In contrast, the Bush Treasury intervened on 97 of 260 business days and sold a record \$19.5 billion of dollars in 1989 alone, in an attempt to restrain the dollar's ____ against the yen and mark."
a) Both the Clinton and the Bush Treasuries were trying to push the dollar up
b) Both the Clinton and the Bush Treasuries were trying to push the dollar down
c) The Clinton Treasury was trying to lower the dollar and the Bush Treasury was trying to raise it
d) The Clinton Treasury was trying to raise the dollar and the Bush Treasury was trying to lower it.

48. "Trade in services is harder to understand because you can't see it, and indeed it is sometimes called ____ trade. For example, if a company uses a consultant based in another country, the payment made to the foreign consultant is considered an ____ in the services account." The blanks are best filled with
a) fictional; import b) fictional; export c) invisible; import d) invisible; export.

49. "Last year Argentina experienced robust growth and fiscal restraint, but some analysts continue to worry about its current account deficit which today is 4% of GDP. But this worry is wrong-headed, because this deficit is the result of the confidence of foreign investors in Argentina's new economic system." This deficit most probably came about because
a) Argentina has a low real interest rate b) of a low Argentine money growth rate
c) foreign investors are importing consumer goods
d) capital inflows have increased the value of the Argentine currency

50. "The dollar was granted a reprieve yesterday from its recent slide against the mark as talk of a rise in German interest rates cooled. But market participants were jittery because a key piece of U.S. economic data was coming their way today: the Labor Department's

report on non-farm payrolls for April." An unexpectedly high level of non-farm payrolls would cause the U.S. dollar to

- a) increase because the Fed would be expected to react by raising interest rates
- b) increase because U.S. agricultural exports would be expected to increase
- c) decrease because the Fed would be expected to react by lowering interest rates
- d) decrease because U.S. agricultural exports would be expected to decrease

51. "The following, attributed to Abraham Lincoln, sums up this argument: 'I don't know much about the tariff. But I do know this much. When we buy manufactured goods abroad we get the goods and the foreigner gets the money. When we buy the manufactured goods at home, we get both the goods and the money.'" Which of the following is not a good counter-argument

- a) with trade we get the goods cheaper
- b) we can always print more money if that's what we want
- c) at full employment buying abroad avoids crowding out
- d) the foreigner will need to spend the money on our goods.

52. "It comes as a surprise to many people that the great advantage of engaging in free trade is not the resulting increase in employment in export industries. In fact, in the long haul free trade has nothing to do with unemployment because" This clipping is best completed with

- a) the economy will remain at the natural rate of unemployment
- b) unemployment changes are wiped out by changes in the terms of trade
- c) there is an offsetting decrease in employment of those working in the import industry
- d) the prices of exports will increase so that there will be no change in employment in export industries

53. "It comes as a surprise to many people that the great advantage of engaging in free trade is not the resulting increase in employment in export industries. In fact, in the long haul free trade has nothing to do with unemployment because" If free trade does not lower unemployment in the long run, what is its great advantage?

- a) it lowers our interest rate
- b) it increases our exchange rate
- c) it increases our standard of living
- d) it lowers unemployment in the short run

54. Suppose that with the same resources the United States can produce two computers or 15 VCRs and Japan can produce one computer or 10 VCRs.

- a) the U.S. has an absolute and a comparative advantage in producing computers
- b) the U.S. has an absolute and a comparative advantage in producing VCRs
- c) Japan has an absolute and a comparative advantage in producing computers
- d) Japan has an absolute and a comparative advantage in producing VCRs

55. Suppose that to produce 10 gallons of wine the United States must forego 3 tons of strawberries and to produce a gallon of wine Mexico must forego two tons of strawberries.

- a) Mexico and the U.S. both have a comparative advantage in wine
- b) Mexico and the U.S. both have a comparative advantage in strawberries
- c) Mexico has a comparative advantage in wine and the U.S. in strawberries
- d) Mexico has a comparative advantage in strawberries and the U.S. in wine

56. To produce 2 tons of steel the U.S. must forego 10 tons of bricks and to produce 5 tons of steel Canada must forego 30 tons of bricks. Canada and the U.S. will specialize in their comparative advantage and trade if the prevailing price of a ton of steel is, in tons of bricks, between

- a) 2 and 5 b) 5 and 6 c) 5 and 15 d) 10 and 30

57. To produce 2 TVs the U.S. must forego 10 stoves whereas to produce 3 TVs Canada must forego 27 stoves. If the prevailing world price of TVs in terms of stoves is

- a) 4, both Canada and the U.S. should produce TVs
 b) 6, Canada should produce stoves and the U.S. should produce TVs
 c) 8, Canada should produce TVs and the U.S. should produce stoves
 d) 10, both Canada and the U.S. should produce stoves

58. "Because the dollar is appreciating and official reserves are rising, it seems evident that demand for the dollar _____ and the central bank was trying to cushion this by _____ dollars on the foreign exchange market." The blanks are best filled with

- a) rose; selling b) rose; buying c) fell; selling d) fell; buying

59. "Before the Europeans increased their investment in our bonds our current account was balanced. With our flexible exchange rate system it was inevitable that our dollar would _____ and our current account would move into _____. The blanks are best filled with

- a) fall; deficit b) fall; surplus c) rise; deficit d) rise; surplus

60. "Alan Blinder, the Fed's newish vice-chairman, insisted that central banks could use interest rates to reduce unemployment, at least for a few years. "____ dollars" said a former European finance minister, summing up many economists' feelings." The blank is best filled with

- a) sell, because lower interest rates will reduce capital inflows and the dollar will fall
 b) buy, because higher interest rates will induce capital inflows and the dollar will rise
 c) sell, because lower unemployment will decrease imports and cause the dollar to fall
 d) buy, because lower unemployment will strengthen the economy and cause the dollar to rise

"China's central bank, the People's Bank of China, has raised the deposit reserve ratio requirement for financial institutions from 6 percent to 7 percent to stem rapid lending growth. An analyst said the central bank had few options because recent verbal admonishments against excessive lending had proved ineffective and raising interest rates would have increased already growing speculative purchases of the Chinese currency." The following four questions relate to this clip.

61. How would raising the deposit reserve ratio stem rapid lending growth?

- a) by decreasing excess reserves in the banking system
 b) by lowering the interest rate
 c) by taxing loans
 d) by shrinking reserves in the banking system

62. Will this succeed in stemming lending growth without increasing the interest rate?
- a) yes, because the interest rate is determined by other forces
 - b) yes, because the Chinese banking system has a fixed interest rate
 - c) no, because less lending happens because the interest rate is lower
 - d) no, because less lending means demand for money is greater than supply
63. Why would a rising interest rate increase speculative purchases of the Chinese currency?
- a) this is incorrect, speculators don't care about the interest rate
 - b) if the interest rate rises foreigners will want to invest in Chinese bonds and so will buy Chinese currency to do so, increasing its price
 - c) a higher interest rate increases exports, increasing the demand for the Chinese currency, increasing its price
 - d) this is incorrect, a higher interest rate decreases bond prices so speculators will stay away
64. Why would the Chinese central bank be against higher interest rates?
- a) they would stimulate an already too-hot Chinese economy
 - b) they would increase the exchange rate which would hurt Chinese exporters
 - c) the central bank would lose control of the monetary sector
 - d) the central bank hates speculators
65. "The strength of the GDP data only highlighted the diverging views between the dollar bulls, who predict that strong growth will support the currency, and the bears who warn that stronger growth will only serve to widen the current account deficit and thus undermine the greenback. Those forces seem to be coming together to keep us right where we are for the time being." What are these two forces?
- a) higher foreign investment and higher imports
 - b) lower foreign investment and higher imports
 - c) higher foreign investment and lower imports
 - d) higher foreign investment and lower imports
66. "The Czech central bank is trying to stop the government issuing the country's maiden sovereign international bond [ie, the first bond issued by the Czech government in a foreign currency (Euros)] next year because it fears it could create another exchange rate bubble." Why would this bond issue create a rise in the value of the Czech currency?
- a) exports should rise
 - b) imports should fall
 - c) capital inflows should increase
 - d) capital outflows should increase
67. "Our leaders have convinced themselves that the falling dollar will improve the economy by eliminating the trade deficit, reducing inflation, and improving our GDP." Which of these three conclusions doesn't make any sense?
- a) eliminating the trade deficit
 - b) reducing inflation
 - c) improving GDP
 - d) they all make sense

68. "The U.S. current account deficit has risen close to 5% of GDP but has not caused a fall in the U.S. dollar because" This clip is best completed with

- a) exports have risen
- b) imports have fallen
- c) capital inflows have increased
- d) capital inflows have decreased

"The U.S. twin deficits are being financed by Asian central banks."

The next three questions refer to this statement.

69. What are the twin deficits?

- a) a budget deficit and a balance of payments deficit
- b) a budget deficit and a current account deficit
- c) a money supply deficit and a balance of payments deficit
- d) a money supply deficit and a current account deficit

70. How are the Asian central banks financing them?

- a) by increasing their imports from the U.S.
- b) by buying U.S. government bonds
- c) by printing Asian money
- d) by raising Asian taxes

71. Why would they do this?

- a) to maintain a low exchange rate with the U.S. dollar
- b) to avoid inflation
- c) to help the U.S.
- d) to earn a lot of interest

72. "In Europe, the weaker dollar has raised fears that a moderate recovery will be dampened." Why would a weaker U.S. dollar affect Europe?"

- a) European exports will fall
- b) European imports will fall
- c) European money supply will shrink
- d) European taxes will need to rise

73. "Exporters want the central bank to lower interest rates."

Why would exporters want lower interest rates?

- a) to reduce inflation
- b) to increase employment
- c) to create multiplier effects
- d) to lower the exchange rate

74. "On a net basis, foreigners sold a record \$22 billion of long-term Treasury debt in November. A repeat performance would fuel market nightmares about _____ Treasury rates and a _____ dollar." The blanks are best filled with

- a) rising; rising
- b) rising; falling
- c) falling; rising
- d) falling; falling

75. "Our nation's national saving rate is now running below 3 percent. In 1960 it was close to 13 percent. Our incredibly low saving rate has led to an incredibly high current account deficit." This high current account deficit has happened because of

- a) a high interest rate
- b) a high exchange rate
- c) high capital inflows
- d) all of the above

Answers: 1a 2d 3d 4b 5b 6a 7c 8b 9d 10b 11a 12a 13a 14a 15a 16c 17a 18c 19b 20c 21a 22a 23a 24c 25c 26c 27c 28c 29d 30d 31a 32c 33b 34a 35a 36a 37b 38c 39a 40c 41d 42a 43d 44d 45b 46c 47d 48c 49d 50a 51d 52a 53c 54a 55d 56b 57b 58a 59c 60a 61a 62d 63b 64b 65a 66c 67b 68c 69b 70b 71a 72a 73d 74a 75c

Chapter 14: Policy in an Open Economy

1. "Finally, there is the question of monetary policy and imported inflation. Under a fixed exchange rate, Canadian inflation would be much more closely tied to that of the U.S.

Given the experience of the last few years, that may not be a bad thing." If a fixed exchange rate were adopted in this situation Canadian monetary policy would

- a) ease
- b) tighten
- c) remain unchanged
- d) become erratic

2. "The British money supply was allowed to increase _____ the German money supply. That difference doomed the policy of aligning the pound to the Deutschmark." The blank is best filled by

- a) faster than
- b) more slowly than
- c) at the same rate as
- d) either a) or b) above

3. "Then there's the state of the dollar, which has been bleeding steadily despite transfusions from borrowings and foreign reserves." Transfusions from borrowings and foreign reserves are

- a) bond sales to foreigners and Fed sales of dollars on the foreign exchange market
- b) bond sales to foreigners and Fed purchases of dollars on the foreign exchange market
- c) bond purchases from foreigners and Fed sales of dollars on the foreign exchange market
- d) bond purchases from foreigners and Fed purchases of dollars on the foreign exchange market

4. "Furthermore, current monetary policy appears to be conducted as if we were on a fixed exchange rate. Policy is effectively geared to maintaining the exchange rate at the expense of a domestic recovery." By conducting monetary policy as if we were on a fixed exchange rate, the Fed

- a) follows the monetarist rule
- b) increases the money supply whenever we have a balance of payments deficit
- c) increases the money supply whenever we have a balance of payments surplus
- d) does not change the money supply in response to balance of payments imbalances

5. "The government may be tempted to increase official currency reserves in order to reduce the pressure on the dollar and the consequent threat to manufacturing industries." What policy is being referred to here?
- having the Fed raise interest rates
 - having the Fed borrow reserves from the IMF
 - having the Fed sell dollars on the foreign exchange market
 - having the Fed buy dollars on the foreign exchange market
6. "The response has been to search out the middle ground. The central bank has a simple operating formula: Some of the adjustment will be taken through the exchange rate, some through interest rates, and the rest through a loss of international reserves." This policy involves
- a fall in the exchange rate and a fall in the interest rate
 - a fall in the exchange rate and a rise in the interest rate
 - a rise in the exchange rate and a fall in the interest rate
 - a rise in the exchange rate and a rise in the interest rate
7. "The central bank, which handles the reserve fund for the government, sells reserves and buys dollars when it wants to" This clipping is best completed with
- prevent the dollar from falling
 - prevent the dollar from rising
 - increase its foreign exchange reserves
 - fix the exchange rate in the face of a balance of payments surplus
8. "By keeping interest rates _____, the bank has attracted offshore investment and created a demand for dollars. In turn, this has pushed _____ the dollar, taking millions of dollars off the bottom lines of exporting companies. To curb the dollar's _____, the bank has periodically entered the foreign exchange market _____." The blanks are best filled with
- high; up the value of; rise; to sell dollars
 - low; up the value of; rise; to sell dollars
 - high; up the value of; rise; to buy dollars
 - low; down the value of; fall; to buy dollars
9. "When the government wants to strengthen the dollar it _____ foreign reserves and _____ domestic dollars. It does the opposite when it wants to keep the dollar from rising too sharply." The blanks are best filled with
- buys; buys
 - buys; sells
 - sells; buys
 - sells; sells
10. "The central bank turned to _____ to stop the Canadian dollar's _____ when it became apparent it was using up reserves to little avail." The blanks are best filled with
- higher interest rates; fall
 - higher interest rates; rise
 - lower interest rates; fall
 - lower interest rates; rise
11. "As interest rates rose by record leaps this week, the dollar continued its slide." What is most likely going on here?
- the rise in interest rates is decreasing exports
 - the rise in interest rates is decreasing capital inflows
 - the slide in the dollar must be causing the Fed to increase interest rates
 - the slide in the dollar is increasing the cost of living and so increasing interest rates

12. "The central bank, fearing inflation, has kept interest rates up. However, to offset the upward pressure those rates are putting on the currency, it has also been....." Complete this clipping.

- a) selling bonds to foreigners
- b) buying dollars on the foreign exchange market
- c) selling dollars on the foreign exchange market

13. "Our international reserves fell by \$330 million to \$3.2 billion last month - not much ammunition if the going gets tough." What is happening here?

- a) there is a balance of payments deficit and the Fed is trying to prevent a rise in the exchange rate
- b) there is a balance of payments deficit and the Fed is trying to prevent a fall in the exchange rate
- c) there is a balance of payments surplus and the Fed is trying to prevent a rise in the exchange rate
- d) there is a balance of payments surplus and the Fed is trying to prevent a fall in the exchange rate

14. "The two-pronged attack - raising interest rates to attract liquid capital into the country and using foreign currency holdings to sop up unwanted dollars - has been designed to" This clipping is best completed with

- a) prevent a fall in the dollar
- b) prevent a rise in the dollar
- c) increase the money supply
- d) deal with a balance of payments surplus

15. "These are the extreme positions. The Bank of Canada's actual path is somewhere in the middle. Some of the brunt of higher U.S. interest rates is taken in higher domestic rates, some through a lower-valued Canadian dollar and some through a loss of international reserves." The upshot of all this is a Canadian balance of payments deficit that is

- a) being allowed to continue
- b) zero because of a lower Canadian dollar
- c) zero because of higher Canadian interest rates
- d) zero because of a combination of higher interest rates and a lower dollar

16. "The floating exchange-rate system has served us well. In recent years, currency flexibility has facilitated adjustment, first to higher inflation, and then to sharp declines in export prices and volumes." The exchange rate first

- a) fell then rose
- b) rose then fell
- c) fell then fell again
- d) rose then rose again

17. "It is surprising that, with the dollar trading so high, the central bank has not allowed some easing of interest rates at the expense of a weaker dollar. Since North America has entered into recession and exports are falling off, clearly the capacity constraints argument with respect to export industries carries less weight." This is an argument for

- a) following the monetarist rule
- b) expansionary monetary policy
- c) contractionary monetary policy
- d) exchange rate manipulation through direct intervention in the foreign exchange market

18. "Official intervention in the foreign exchange market does appear to be a useful policy, when overshoots take place in fragile circumstances, he said." How would this intervention work?

- a) capital outflows would be restricted if the exchange rate rises above its equilibrium value
- b) dollars would be sold in the foreign exchange market if the exchange rate rises above its equilibrium value
- c) dollars would be sold in the foreign exchange market if the exchange rate falls below its equilibrium value
- d) dollars would be bought in the foreign exchange market if the exchange rate rises above its equilibrium value

19. "Reagan's own Council of Economic Advisors put the case for a muscular dollar with surprising force: The strong dollar has stimulated production and investment in sectors less involved in international trade. In other industries, competition from imports has prompted more expenditure in plant and equipment as well as greater attention to controlling wages and other costs. Prices of traded goods and close substitutes have been kept lower than they would have been otherwise, thereby benefiting both U.S. consumers and U.S. producers who use imported inputs." In a nutshell, the argument for a muscular dollar is that it

- a) fights inflation
- b) cuts down on imports
- c) prevents unemployment
- d) avoids balance of payments deficits

20. "Most economists ignore the supply-side effects of exchange rate changes. He thinks the supply-side effects make the impact of a devaluation much less palatable." The supply-side effects of a devaluation are that it increases

- a) costs
- b) competition
- c) productivity
- d) import profitability

21. "By avoiding policies to slow the growth of domestic demand and instead forcing the U.S. dollar to serve as the adjustment vehicle in narrowing the trade deficit, the United States will ensure that the global economic landscape during the next five years will be turned upside down." The main implication of this is that

- a) the U.S. dollar will rise
- b) the U.S. dollar will fall
- c) U.S. unemployment will rise
- d) the U.S. interest rate will rise

22. "The dollar has been falling largely because it was overvalued during the first half of the 1980s. The Fed's tight monetary policy drove up interest rates in an attempt to smother inflation and hold wages down." The dollar became overvalued because

- a) exports were extremely high
- b) there was a balance of payments deficit
- c) high interest rates created large capital inflows
- d) the Fed intervened in the foreign exchange market to increase the value of the dollar

23. "Japanese officials and many private economists say the stronger yen will initially cause Japan's trade surplus to rise because it inflates the U.S. dollar value of Japanese exports even though volume may be falling." This reflects the impact of

- a) capital inflows
- b) interest rate changes
- c) the J curve phenomenon
- d) a chronic current account deficit

24. "Speculators are clearly betting that a French franc will soon buy fewer German marks. While France and Germany apparently have had the financial muscle to fend off the speculators so far, it is not clear whether they are prepared to pay the price of a disrupted economy for a prolonged period." This disruption is
- a) inflation in both France and Germany
 - b) unemployment in both France and Germany
 - c) unemployment in France and inflation in Germany
 - d) inflation in France and unemployment in Germany
25. "Canada's official international reserves rose to an all-time high in October as the Bank of Canada acquired close to US\$600 million trying to" This clipping is best completed with
- a) prevent a fall in the Canadian dollar
 - b) prevent a rise in the Canadian dollar
 - c) shrink the Canadian money supply
 - d) find financing for the government deficit
26. "Indeed, the yen may have to stay strong for two years or more, many experts say, to have much impact on American-Japanese trade." This is because of
- a) the J curve
 - b) capital inflows
 - c) high U.S. interest rates
 - d) high Japanese interest rates
27. A country with an undervalued currency
- a) is hurting exporters
 - b) will have a balance of payments deficit
 - c) will accumulate reserves of foreign currency
 - d) will experience downward pressure on its exchange rate
28. A sterilization policy applied after a decrease in the money supply should cause
- a) the exchange rate to flex
 - b) no change in our foreign exchange reserves
 - c) our foreign exchange reserves continually to fall
 - d) our foreign exchange reserves continually to rise
29. The existence of the international sector causes fiscal policy to
- a) be weaker, but only under fixed exchange rates
 - b) be stronger, but only under fixed exchange rates
 - c) be stronger, but only under flexible exchange rates
 - d) be completely ineffective, but only under a fixed exchange rate
30. Under flexible exchange rates a small open economy should
- a) lose control of its monetary policy
 - b) be insulated from its trading partners' inflation
 - c) tend to experience the inflation of its trading partners
 - d) find that changes in its interest rates match changes in its trading partner's interest rates
31. A country that is buying its own currency to maintain a given exchange rate
- a) has a flexible exchange rate
 - b) has an undervalued currency
 - c) has a balance of payments surplus
 - d) is automatically decreasing its money supply
32. Expansionary monetary policy under fixed exchange rates in the short run tends to
- a) reduce an inflationary gap and reduce a trade surplus
 - b) lower the domestic rate of interest and increase a trade surplus
 - c) decrease a trade surplus and increase short-term capital inflows
 - d) increase a trade surplus and increase short-term capital inflows

- d) reduce a recessionary gap and increase short-term capital outflows
33. The central bank, which handles the foreign exchange reserve fund for the government, sells reserves and buys dollars when it wants to
- a) lower the interest rate
 - b) stimulate economic activity
 - c) stimulate demand for exports
 - d) prevent the exchange rate from falling
34. Under a fixed exchange rate the influence of international forces causes a stimulating dose of fiscal policy
- a) to appreciate the value of the dollar
 - b) to have a smaller impact on GDP
 - c) to create a balance of payments deficit
 - d) to increase our foreign exchange reserves
35. If the Fed is buying \$US in the foreign exchange market to maintain the value of the \$US, then
- a) the U.S. dollar is undervalued
 - b) the U.S. money supply is shrinking
 - c) the US has a balance of payments surplus
 - d) U.S. foreign exchange reserves are rising
36. "But adopting fixed exchange rates entails a steep price, namely, that the government is prohibited from using _____ to fight slumps. The upshot is a neat illustration of the "no-free-lunch" maxim so beloved by economists." The blank is best filled in with
- a) fiscal policy
 - b) tariff policy
 - c) monetary policy
 - d) supply-side policy
37. "The depression in Asia and the fall in Asian exchange rates acts as a coolant to keep the U.S. engine of growth from overheating." The cooling comes about because lower Asian exchange rates
- a) increase demand for U.S. exports
 - b) increase the cost of U.S. imports
 - c) mean increased competition for U.S. producers
 - d) force U.S. producers to increase aggregate supply
38. "Last week, as arguments over the Bank's latest move rattled around the financial community, the majority view was that the Bank of Canada had blundered. The dollar's decline was what many economists call an external shock - the Asian financial crisis has sent commodity prices tumbling - and the Bank should have" This clipping is best completed by
- a) allowed the dollar to fall to alleviate inflationary forces
 - b) allowed the dollar to fall to cushion decreases in Canadian exports
 - c) protected the value of the Canadian dollar to ensure domestic stability
 - d) protected the value of the Canadian dollar to cushion decreases in Canadian exports
39. "One has to be very careful in talking about exchange rate stability to recognize that goals trade off," Lawrence H. Summers, the deputy treasury secretary, told a Senate panel last month, "and that to pursue exchange rate stability as a goal, one inevitably gives something else up." What is given up by pursuing exchange rate stability?
- a) fiscal policy
 - b) monetary policy
 - c) tariff policy
 - d) incomes policy
40. "The majority view on fixed exchange rates is that they aren't worth the cost for most countries because they can require painful actions in the domestic economy, such as" This clipping is best completed with

- a) using an inappropriate fiscal policy when in recession
- b) using an inappropriate monetary policy when in recession
- c) the imposition of inappropriate tariffs when in recession
- d) applying inappropriate incomes policies when in recession

41. "The deal won't hold together if, say, recession-bound Spaniards are screaming for easy money while inflation-wary Germans want to keep money tight." What deal is being talked about here?

- a) a common currency
- a) a flexible exchange rate
- c) a full employment guarantee
- d) freedom to operate independent monetary policies

42. "For many years the driving force behind the global economy has been a tacit agreement between the U.S. and China. The U.S. provides a ready market for cheap Chinese goods and keeps mostly silent about the way China manages its currency and despoils its environment to sustain growth. In return, China helps finance" This clipping is best completed with

- a) investment spending in the U.S.
- b) consumption spending in the U.S.
- c) U.S. imports
- d) the U.S. budget deficit

43. "Yesterday the Fed announced the stunning decision that it would buy up to \$300 billion of long-term US Treasury bonds to help jolt the economy out of its deep depression." This action would help jolt the economy out of recession because

- a) \$300 billion of extra spending is a huge stimulating fiscal policy
- b) it increases the money supply dramatically
- c) taxes will fall because less government spending needs to be financed
- d) the exchange rate will increase markedly

44. "Speculation that Japan would not intervene ahead of the meeting helped yen bulls weaken the dollar to ¥113.58, a level not seen since January 2001" Before the exchange rate moved to ¥113.58, what would have been a more likely exchange rate, and how would Japan have intervened had it wanted to?

- a) ¥110.58; by buying yen on the foreign exchange market
- b) ¥110.58; by selling yen on the foreign exchange market
- c) ¥115.58; by buying yen on the foreign exchange market
- d) ¥115.58; by selling yen on the foreign exchange market

45. "Normally, an overheating economy would demand higher interest rates to keep inflation in check, but the Bank of Canada said the Canadian dollar and the situation in the U.S. have allowed it to hold its key interest rate steady yesterday." What must be happening with the Canadian dollar and the U.S?

- a) dollar high; U.S. in recession
- b) dollar low; U.S. in recession
- c) dollar high; U.S. in boom
- d) dollar low; U.S. in boom

46. “Cheng said that China should shift part of its \$US 1.4 trillion in foreign exchange reserves out of U.S. dollars and into other, stronger currencies. But Gilmore replied that this would cause a run on the dollar and China will not drive a run on the dollar, not now and not ever.” What is the reasoning behind the view that China will never drive a run on the dollar?

- a) China likes the U.S. and would never do anything to harm it
- b) there would be no run on the dollar here because other countries would be buying these dollars
- c) if the value of the dollar fell, China would suffer a huge loss in the value of its \$US foreign exchange reserves
- d) if the value of the dollar fell, so would the value of the Chinese currency, making China’s exports more expensive

47. “The U.S. bond market sold off in overnight trading on a report of Chinese selling of treasuries. The *China Business News* reported that China has started reducing its massive holdings of U.S. treasuries because the dollar’s decline is causing them to lose value.” If China did this then

- a) the interest rate would increase and the dollar’s decline would moderate
- b) the interest rate would increase and the dollar’s decline would accelerate
- c) the interest rate would decrease and the dollar’s decline would moderate
- d) the interest rate would decrease and the dollar’s decline would accelerate

48. “Many countries peg their own currencies to the greenback; these countries import U.S. inflation when the Fed makes a mistake.” Why would these countries “import” inflation.

- a) this is incorrect because countries only import goods or services
- b) this is incorrect because inflation is determined by your country’s own money growth rate
- c) this is correct because a fixed exchange rate means that your country must experience the inflation of the country to which your exchange rate is fixed
- d) this is correct because higher inflation in the U.S. will increase your imports and decrease your exports, creating a balance of payments deficit and so inflation

49. “The fund also said Russia should focus on cutting inflation by allowing a more flexible exchange ruble rate.” What must currently be happening with regard to the exchange rate?

- a) there is a balance of payments surplus and the exchange rate is trying to rise
- b) there is a balance of payments surplus and the exchange rate is trying to fall
- c) there is a balance of payments deficit and the exchange rate is trying to rise
- d) there is a balance of payments deficit and the exchange rate is trying to fall

Answers: 1b 2d 3b 4c 5c 6b 7a 8a 9c 10a 11c 12c 13b 14a 15a 16c 17b 18b 19a 20a 21b 22c 23c 24c 25b 26a 27c 28d 29b 30b 31d 32d 33d 34d 35b 36c 37c 38b 39b 40b 41a 42d 43b 44c 45a 46c 47b 48c 49a

Chapter 15: Purchasing Power Parity

1. "In three to five years, the U.S. dollar will presumably resume its long-term slide unless Washington reverses its economic policies of the post-Second World War period and takes a tough stand against inflation." A tough stand against inflation would stop the slide of the dollar because
 - a) capital inflows will decrease
 - b) with less inflation the demand for money rises, increasing its value
 - c) the required tight monetary policy will decrease the demand for money
 - d) lower inflation makes exports more attractive, increasing the demand for our currency

2. "News that job creation in January was more robust than anticipated sent a signal to currency markets to expect a stepped-up fight against inflation, unleashing a bout of buying fervor for the dollar." People would buy the dollar because
 - a) a stepped-up fight against inflation means higher real interest rates
 - b) higher employment means higher income and so higher imports
 - c) higher employment means more income and so higher demand for money
 - d) lower inflation means lower interest rates and so a higher demand for money

3. "This is the reason why the fixed exchange rate system was scrapped in 1971. The U.S. had been pursuing an inflationary monetary policy to help pay for the Vietnam war and new social programs, and its trading partners did not all want to participate in it." To avoid participating in this inflation a trading partner would have to adopt a flexible exchange rate and
 - a) raise its money growth rate and allow its currency to appreciate steadily
 - b) raise its money growth rate and allow its currency to depreciate steadily
 - c) lower its money growth rate and allow its currency to appreciate steadily
 - d) lower its money growth rate and allow its currency to depreciate steadily

4. "The report said that the dollar has already fallen in the last half-dozen years and raises the question of why things have not gone better if exchange rate depreciation is so good for the economy." The lower dollar has not stimulated this economy because it has been offset by

a) inflation	b) capital inflows
c) a current account deficit	d) contractionary monetary policy

5. "News that U.S. job creation in January was more robust than anticipated sent a signal to currency markets to expect a stepped-up fight against inflation, unleashing a bout of buying fervor for the U.S. dollar." The main reason people were buying the U.S. dollar is because
 - a) according to PPP it should depreciate
 - b) job creation increases imports which should appreciate the dollar
 - c) fighting inflation involves a rise in interest rates which should appreciate the dollar
 - d) fighting inflation involves decreasing the money supply by buying dollars on the foreign exchange market

6. "If Ukrainian prices hadn't risen in line with Russia, market forces would have sucked Ukraine dry of food and consumer goods as Russians sought cheaper goods than they could get at home." How would this result have been different if both areas had their own currencies?

- a) the Ukraine currency would have fallen and the Russian currency risen
- b) the Ukraine currency would have risen and the Russian currency fallen
- c) the currency values would not have changed because offsetting capital inflows to Russia would have occurred
- d) the currency values would not have changed because offsetting capital inflows to the Ukraine would have occurred

7. "All countries that consistently run lower inflation rates than their trading partners over a long period of time have an upward trend in their....." This clipping is best completed with

- a) exports
- b) interest rate
- c) exchange rate
- d) unemployment rate

8. "How does the average Chinese survive on just enough money each month for 17 Big Macs - which is what official Chinese per capita income implies? The answer is, of course, that he doesn't, because converting incomes at current exchange rates doesn't reflect" This clipping is best completed with

- a) tax differences
- b) inflation differences
- c) cost of living differences
- d) actual supplies of and demands for the currencies

"A second issue concerns how long the fixed exchange rate could be maintained. This, of course, depends on an uncertain future, but if the initial value chosen was appropriate and if domestic costs remained in line with foreign costs, then the rate may be sustainable for some time."

9. If domestic costs remain in line with foreign costs then these countries must have similar

- a) tax rates
- b) interest rates
- c) inflation rates
- d) unemployment rates

10. If domestic costs rose above foreign costs then

- a) a balance of trade deficit would develop
- b) a balance of trade surplus would develop
- c) the balance of payments would be affected, but not the balance of trade
- d) capital inflows would adjust automatically to prevent an imbalance in the balance of trade

11. "While the table shows that there are more countries against which the U.S. dollar has appreciated over the past 12 months rather than depreciated, the extra local currency that a fixed U.S. dollar outlay will buy is not necessarily a great windfall to the U.S. traveler." The U.S. traveler may not find this to be a windfall because it has been offset by

- a) capital inflows
- b) tax differences
- c) higher foreign prices
- d) direct intervention by the central bank in the foreign exchange market

12. "Word that growth in the cost of living was slower in the United States than in Germany last year attracted buyers for the" This clipping is best completed with

- a) U.S. dollar because PPP predicts that the U.S. dollar should rise
- b) German mark because PPP predicts that the German mark should rise
- c) U.S. dollar because relatively lower prices in the U.S. should create a U.S. balance of payments deficit
- d) German mark because relatively higher prices in Germany should create a German balance of payments surplus

13. "The conventional wisdom has been that inflation is bad for the economy. If our inflation is running higher than our trading partners' inflation, according to this argument, our growth slows and jobs are lost." Does this logic assume a fixed or flexible exchange rate?

- a) fixed - our balance of payments surplus makes exports more difficult
- b) fixed - our money supply is automatically contracted, causing unemployment
- c) flexible - central bank intervention in the foreign exchange market inhibits exports
- d) flexible - our exchange rate automatically increases, decreasing exports, causing unemployment

14. "Monday's trade figures - twice as bad as analysts were generally expecting them to be - reinforced fears that the economy was overheating, with imports outstripping exports and inflationary pressures surging. The government is now expected to raise interest rates almost immediately." Higher interest rates are appropriate because they

- a) lower the exchange rate
- b) raise costs and so cut back demand
- c) dampen aggregate demand directly and through raising the exchange rate
- d) attract capital inflows, increasing aggregate supply to alleviate the inflation

"Foreign countries are now free to pursue an independent course of monetary policy, and old conflicts about the U.S. role in exporting inflation and about the adjustment responsibilities of surplus (or deficit) nations suddenly seem to have lost their relevance."

15. U.S. inflation would be exported if

- a) the exchange rate were fixed
- b) it charged more for its exports
- c) the exchange rate were flexible
- d) it increased its money growth rate

16. The adjustment responsibilities referred to are that surplus and deficit countries must

- a) both experience inflation
- b) both experience unemployment
- c) experience inflation and unemployment, respectively
- d) experience unemployment and inflation, respectively

17. "The record has not been good. Our past experience with exchange rate depreciation has been that all too often it has led, not to a sustained improvement in our competitiveness, but to" Complete this clipping.

- a) a rise in our unemployment
- b) a fall in our prices and wages
- c) no change in our competitiveness
- d) a deterioration in our competitiveness

18. "Why has he argued for a stable dollar and a zero inflation? Aren't these inconsistent goals?" These goals are

- a) consistent because a stable dollar means zero inflation

b) consistent because PPP says that when we have zero inflation our exchange rate will be unchanging

c) inconsistent because our exchange rate should fall continuously if our prices don't increase by as much as those of our trading partners

d) inconsistent because PPP says that our exchange rate continually changes unless our trading partners have an identical inflation rate

19. "While acknowledging that a weaker dollar initially favors exports, he said this advantage will only last as long as" Complete this clipping.

a) the exchange rate remains lower

b) exporters continue to market their products aggressively

c) our inflation does not fall below that of our trading partners

d) our prices do not rise to offset the advantage of the lower exchange rate

20. "The PPP exchange rate between two currencies is in equilibrium when it leaves a typical consumer bundle costing the same in each country. Comparing actual exchange rates with PPPs is one indication of whether a currency is under- or over-valued." What meaning would be attached to a statement that a currency is undervalued by this PPP measure?

a) that country must have a lower cost of living

b) that country must have a higher cost of living

c) that country must have a balance of payments deficit

d) that country must have a balance of payments surplus

21. "Tying the Canadian dollar to the U.S. dollar may eliminate some worries, but it will create others, among them concern that the U.S. might not be as dedicated as Canada is to fighting inflation." This is of concern to Canadians because Canada will be

a) unable to adopt its own fiscal policy

b) forced to experience the higher U.S. inflation rate

c) forced to experience a continual balance of payments deficit

d) forced to have a dramatically higher nominal interest rate than the U.S.

22. "The surest way to sustain the exchange value of our currency is to maintain its purchasing power at home." The rationale behind this statement is that PPP says that

a) low inflation will cause our exchange rate to fall slowly

b) zero inflation will cause our exchange rate to be constant

c) high inflation will cause our exchange rate to rise quickly

d) inflation lower than our trading partners' inflation causes our exchange rate to rise

23. "Switzerland used to boast one of the lowest inflation rates in the world and one of the strongest currencies, thanks to sound monetary policies and prudent public finances." Low inflation creates a strong currency if

a) unemployment is low

b) the exchange rate is fixed

c) the interest rate is kept low

d) the exchange rate is flexible

24. "But economic theory and our own experience tell us that using monetary policy to drive down the exchange rate will be successful only until" This is best completed with.

- a) the resulting trade deficit wipes it out
- b) prices rise to restore the real exchange rate
- c) prices rise to restore the nominal exchange rate
- d) prices fall to restore the nominal exchange rate

25. "Exporters and some economists have argued that the central bank should drive _____ the value of the dollar to boost economic activity. The Fed claims, however, that its ability to influence the _____ exchange rate is severely limited." The blanks are best filled with

- a) up; real
- b) down; real
- c) up; nominal
- d) down; nominal

"If inflation exists in the rest of the world, but not in Canada, Canada's merchandise trade surplus should soar with exports becoming cheap and imports expensive. Of course, that would stimulate economic activity in Canada and, pretty soon, the inflation rate would begin to rise. How would the authorities counter that undesirable development? By keeping money growth low and interest rates much higher than U.S. interest rates - the same way that the Bank of Canada has fought inflation in the past and still does today."

26. Under a fixed exchange rate this thinking is wrong because

- a) fighting inflation is futile in this context
- b) the merchandise trade surplus should not develop
- c) low money growth and high interest rates cannot attack inflation
- d) it is the balance of payments that is important, not the balance of trade

27. Under a flexible exchange rate this thinking is wrong because

- a) the merchandise trade surplus should not develop
- b) the exchange rate will be prevented from continually falling
- c) low money growth and high interest rates cannot attack inflation
- d) low money growth is not feasible in the face of large balance of payments surpluses

28. "An even better case study is Singapore. The Singapore Monetary Authority deliberately targets a trend appreciation in the Singapore dollar versus the U.S. dollar in order to maintain price stability." This implies that

- a) Singapore should experience zero inflation
- b) Singapore should experience an inflation rate equal to that of the U.S.
- c) Singapore should experience an inflation rate higher than that of the U.S., by an amount equal to its trend appreciation rate
- d) Singapore should experience an inflation rate lower than that of the U.S., by an amount equal to its trend appreciation rate

29. "From their perspective, the only other way to lower interest rates is for the Fed to increase the supply of funds by continuously pumping more money into the economy. But they argue against such a _____ monetary policy, claiming it would not be tolerated for long by the financial markets since it would lead to a further _____ in the value of the dollar and more _____." The blanks are best filled with

- a) tight; fall; inflation
- b) loose; fall; inflation
- c) tight; rise; unemployment
- d) loose; rise; unemployment

30. "Our trade account has remained in a deep deficit even though the dollar has fallen sharply over the past four years, a development that normally would have led to an improvement in trade figures." Trade figures have not improved because the

- a) nominal exchange rate must have increased
- b) fall in the dollar was offset by a rise in our prices
- c) fall in the dollar was offset by a rise in our interest rates
- d) fall in the dollar was only a fall in the real exchange rate

31. "The central bank can defend the long-term external value of our currency only by defending its internal value." The rationale behind this statement is that high exchange rates result from

- a) high prices
- b) low inflation
- c) high inflation
- d) low real interest rates

32. "There is no historical evidence of countries finding enduring prosperity in a strategy of currency devaluation: We cannot devalue our way to the kind of competitive, high-performance economy we want." The logic behind this is that

- a) exchange rate devaluations decrease competition
- b) high-performance economies imply rising currency values
- c) currency devaluations are usually offset by domestic price increases
- d) currency devaluations are usually offset by domestic price decreases

33. "Economists claim that a strong dollar is a result of the Fed's pitched battle against inflation." The rationale for this claim is that

- a) according to PPP, if inflation becomes lower than foreign inflation, the exchange rate should rise
- b) to battle inflation the Fed raises the real interest rate, causing capital inflows which bid up the exchange rate
- c) lower inflation means exports go up and imports down, creating a balance of payments surplus which bids up the value of the dollar
- d) all of the above

34. Suppose the U.S. and Canadian economies, on a flexible exchange rate, are both experiencing a real growth rate of 3 percent, but that the Canadian money supply growth rate is 10 percent compared to only 6 percent in the U.S. Currently, 1 U.S. dollar buys 1.2 Canadian dollars. How many Canadian dollars would you guess 1 U.S. dollar will buy two years from now?

- a) 1.2 or less
- b) more than 1.2 but not more than 1.25
- c) more than 1.25 but not more than 1.3
- d) more than 1.3

35. Suppose the real rates of growth in the United States and Canada are both 2 percent, inflation in Canada is 9 percent and the U.S. dollar is appreciating against the Canadian dollar by 4 percent per year. What is the U.S. money growth rate?

- a) 4% or less
- b) more than 4% but not more than 6%
- c) more than 6% but not more than 8%
- d) more than 8%

36. Suppose that in mid-1990 one U.S. dollar bought 1.1 Canadian dollars and in mid-1992 it bought 1.2 Canadian dollars. During this period the annual rate of inflation in the

U.S. was 5 percent and in Canada was 8 percent. During this period the U.S. real exchange rate has

- a) increased by 8% or more
- b) increased by less than 8%
- c) decreased by 8% or more
- d) decreased by less than 8%

37. Suppose the U.S. and Canadian economies, on a flexible exchange rate, are in mutual equilibrium with a common real growth rate of 2%, Canadian money growth of 5% and U.S. money growth of 8%. Then the U.S. dollar should be

- a) depreciating by 2% or less per year
- b) appreciating by 2% or less per year
- c) depreciating by more than 2% per year
- d) appreciating by more than 2% per year

38. Suppose that in mid-1991 one U.S. dollar bought 1.1 Canadian dollars and in mid-1992 it bought 1.2 Canadian dollars. During this period the annual rate of inflation in the U.S. was 5 percent and in Canada was 18 percent. During this period the U.S. real exchange rate has

- a) increased by 8% or more
- b) increased by less than 8%
- c) decreased by 8% or more
- d) decreased by less than 8%

39. Suppose a typical basket of goods and services consists of 4 units of housing and 7 units of food. In the United States a unit of housing costs 2 U.S. dollars and a unit of food costs one U.S. dollar; in Canada these prices are 3 Canadian dollars and 2 Canadian dollars, respectively. If the current exchange rate is 1.5 Canadian dollars per U.S. dollar, what is the purchasing power parity exchange rate?

- a) 1.3 \$C/\$US or less
- b) more than 1.3 \$C/\$US but not more than 1.5 \$C/\$US
- c) more than 1.5 \$C/\$US but not more than 1.7 \$C/\$US
- d) more than 1.7 \$C/\$US

40. Suppose the American and Canadian economies are in equilibrium with a fixed exchange rate of 1.3 \$C/\$US and a common inflation rate of 5 percent. If the U.S. increases its money growth rate by two percentage points, when these economies have settled to their new mutual equilibrium the exchange rate (\$C/\$US)

- a) will be unchanged in both nominal and real terms
- b) will be unchanged in nominal terms but higher in real terms
- c) will be unchanged in nominal terms but lower in real terms
- d) will be unchanged in real terms but lower in nominal terms

41. Suppose the American and Canadian economies are in equilibrium with a flexible exchange rate of 1.3 \$C/\$US and a common inflation rate of 5 percent. If the U.S. increases its money growth rate by two percentage points, when these economies have settled to their new mutual equilibrium the exchange rate (\$C/\$US)

- a) will be unchanged in both nominal and real terms
- b) will be unchanged in nominal terms but lower in real terms
- c) will be unchanged in real terms but higher in nominal terms
- d) will be unchanged in real terms but lower in nominal terms

42. In 1975 the Canada/US exchange rate was 1.02 (i.e., 1\$US bought 1.02\$C). The Canadian price level rose by 52% between 1975 and 1980, while the US price level rose by 41%. What does PPP predict is the 1980 exchange rate?

- a) below 1.00
- b) between 1.00 and 1.10

- c) between 1.10 and 1.20 d) above 1.20

43. If five French francs buy one dollar and fifty thousand French francs buy in France a typical bundle of goods and services that costs twenty thousand dollars to buy in the U.S., then the PPP exchange rate is

- a) 2 francs per dollar b) 2.5 francs per dollar
c) 4 francs per dollar d) 5 francs per dollar

44. If in the U.S. inflation is 8% but in Canada is only 3%, under a flexible exchange rate

- a) Canada's exports should be rising and imports falling
b) Canada's exchange rate should be rising in real terms
c) Canada's exchange rate should be steady in real terms
d) Canada's exchange rate should be falling in nominal terms

45. If in the U.S. inflation is 8% but in Canada is only 3%, under a flexible exchange rate

- a) Canada's nominal and real exchange rates should be rising
b) Canada's nominal and real exchange rates should be constant
c) Canada's nominal exchange rate should be constant and real exchange rate rising
d) Canada's nominal exchange rate should be rising and real exchange rate constant

46. If the U.S. money growth rate increases by two percentage points, then under a fixed exchange rate when equilibrium is reattained

- a) Canada's nominal and real exchange rates should be higher
b) Canada's nominal and real exchange rates should be constant
c) Canada's nominal exchange rate should be higher and real exchange rate constant
d) Canada's nominal exchange rate should be constant and real exchange rate higher

47. If we are at full employment and the rate of growth of our money supply increases, in the long run we should expect

- a) a fall in bond prices and our exchange rate
b) an increase in bond prices and our exchange rate
c) an increase in bond prices and a fall in our exchange rate
d) a fall in bond prices and an increase in our exchange rate

48. In countries experiencing hyperinflation we should see

- a) low interest rates and a depreciating currency
b) high interest rates and a depreciating currency
c) low interest rates and an appreciating currency
d) high interest rates and an appreciating currency

49. "In 1993, for example, the peso declined 0.6% whereas consumer prices rose 9.8% in Mexico versus just 2.5% in the United States. This led to an _____ of the peso, causing a current account _____, contributing to the forces causing the Mexican financial crisis of December 1994." The blanks are best filled with

- a) undervaluation; deficit b) undervaluation; surplus
c) overvaluation; deficit d) overvaluation; surplus

50. "An even better case study is Singapore. The Singapore Monetary Authority deliberately targets a trend appreciation in the Singapore dollar versus the U.S. dollar in order to maintain price stability." This policy implies that when the Singapore dollar appreciates by more than the target trend rate, the Singapore Monetary Authority should
- increase its money growth rate
 - decrease its money growth rate
 - hold its money growth rate constant
 - alter the money growth rate up or down, depending on the unemployment rate
51. "Aside from the much-needed interest rate relief, the U.S. economy will continue to benefit from significantly improved terms of trade." What is meant by "improved terms of trade"?
- a balance of trade surplus
 - lower tariffs
 - higher world prices for our exports relative to our imports
 - a higher exchange rate
52. "The dollar's decline cuts two ways for Americans." What are these two ways?
- higher exports but higher imports
 - lower prices but higher costs
 - higher exports but higher prices
 - higher imports but lower costs
53. "The greenback fell against currencies around the world on the stunning decision by the Fed to buy up to \$300 billion of long-term US Treasury bonds to help jolt the economy out of its deep depression." The US dollar fell because
- nobody believed that this would move the US out of its deep depression
 - of fears of US inflation
 - of the consequent rise in the US interest rate
 - the clip is incorrect – the US greenback rose because buying dollars increases their price

Answers: 1d 2a 3c 4a 5c 6b 7c 8c 9c 10a 11c 12a 13b 14c 15a 16c 17c 18d 19d 20a 21b 22d 23d 24b 25b 26a 27a 28d 29b 30b 31b 32c 33d 34c 35c 36b 37c 38d 39d 40a 41d 42c 43b 44c 45d 46b 47a 48b 49c 50a 51c 52c 53b

Chapter 16: Interest Rate Parity

1. "At the same time that Secretary Blumenthal was testifying to Congress, the Treasury borrowed \$1.6 billion in Germany in the form of securities denominated in marks. It offered to pay a interest rate of roughly 6% per year on mark-denominated three- and four-year securities. On comparable securities denominated in dollars, the Treasury is currently paying a bit over 9% - or three percentage points per year more." Germans are willing to invest at 6% when 9% is available because

- a) they are very nationalistic b) the risk premium is not large enough
- c) they expect the value of the US dollar to fall by more than 3% per year
- d) they expect the value of the German mark to rise by less than 3% per year

2. "He can't understand why Americans would put their money in three-year paper at 9% when they can get double-A rated New Zealand bonds at 19%." This happens because of

- a) a huge risk premium b) ignorance on the part of U.S. investors
- c) a higher inflation in New Zealand than in the U.S.
- d) an expected rise in the value of the New Zealand dollar.

3. "The Fed has made occasional attempts to lower interest rates and accept some lowering of the dollar as a tradeoff. Sometimes it works, and sometimes, like last summer, we end up with the worst of all possible worlds - higher interest rates and a lower dollar." This worst of all possible worlds most likely happened because the Fed effort to lower interest rates

- a) increased inflation which increased the nominal interest rate and depreciated the dollar
- b) caused capital inflows to fall, lowering the exchange rate which raised costs and thus increased the interest rate
- c) caused a balance of payments surplus which automatically increased the money supply, causing inflation which lowered the exchange rate and increased the nominal interest rate
- d) increased the money supply which under a flexible exchange rate depreciated the dollar which required a higher interest rate to attract capital inflows for international balance

4. "This does not mean there is a massive flow of U.S. funds into Canada, because the differentials are mitigated by other factors. The discount on the forward Canadian dollar has kept step with the interest rate differential, and it is only on an unhedged basis that the full advantage of the differential can be gained." The discount on the forward Canadian dollar keeping in step with the interest rate differential means that the interest rate differential

- a) should produce a steady rise in the value of the Canadian dollar
- b) is producing capital flows that are causing expected changes in the exchange rate
- c) is a difference in real interest rates and so influences the future value of the exchange rate
- d) reflects inflation differentials and so the exchange rate is expected to change by an equal amount

5. "Before the advent of modern international financial markets in the mid 1970s, domestic financial markets placed a serious constraint on the ability of governments to borrow their way to popularity or prosperity. Historically, domestic financial markets were largely closed systems where excessive borrowing by governments led quickly to" Complete this clipping.

- a) inflation b) lower taxes c) unemployment d) higher interest rates

6. "The 4.8 percent yield on Japanese short-term securities is due to a strong yen; Australia's 16.1 percent yield is a product of its weak dollar." The most reasonable explanation for these numbers is that

- a) Japan has a low inflation rate and Australia a high inflation rate
- b) interest rates are not relevant here - Japan must have a balance of payments surplus and Australia a balance of payments deficit
- c) the explanation should be reversed - the weak dollar is creating a high Australian interest rate and the strong yen is creating a low Japanese interest rate
- d) there is a typo - the numbers should be reversed - the high interest rate is creating capital inflows making the Australian currency strong and the low interest rate is making the yen weak

7. "In a forward contract, the bank guarantees the exchange rate for the investor when the issue is bought, so the investor is protected against a fall in the exchange rate. But there's a catch: _____. This usually renders the actual yield on the foreign bonds _____ the yield on domestic bonds." Assuming a zero risk premium, the blanks are best filled with

- a) the cost is more than the actual fall in the exchange rate; equal to
- b) the cost is more than the actual fall in the exchange rate; less than
- c) the cost is more than the expected fall in the exchange rate; equal to
- d) the cost is more than the expected fall in the exchange rate; less than

8. "Higher inflation in both Germany and Japan has pushed up their interest rates. What he doesn't understand is why the U.S. interest rate hasn't followed suit. He claims that international financial markets are so closely integrated these days that the U.S. interest rate reaction should have been apparent by now." The U.S. interest rates have not risen because

- a) inflation in the U.S. has not increased
- b) the lower U.S. interest rate is a lower real, not a lower nominal rate
- c) the Fed has increased the U.S. money supply to keep its interest rate low
- d) the U.S. is too large an economy to be influenced by foreign interest rates

9. "What are the factors behind the recent decline in the value of the dollar? A speculative blip can be ruled out as the reason because the currency was selling at a forward premium for most of the period." A forward premium implies that the

- a) real exchange rate is expected to increase
- b) real exchange rate is expected to decrease
- c) nominal exchange rate is expected to increase
- d) nominal exchange rate is expected to decrease

10. "He believes that Canada's lower inflation rate could lead to tighter spreads between Canadian and U.S. interest rates." This would happen because

- a) the closer Canada's inflation gets to zero, the closer it's interest rate will be to that of the U.S.
- b) the closer Canada's inflation gets to U.S. inflation, the closer it's interest rate will be to that of the U.S.
- c) from IRP, lower inflation means a lower risk premium, moving Canada's interest rate closer to that of the U.S.
- d) from PPP, lower inflation means a rising exchange rate which will force Canada's interest rate down to that of the U.S.

11. "Canadians must convince investors and speculators that the Canadian dollar will hold its value. For the moment, that means Canada must decisively match U.S. interest rates. Paradoxically, in the past Canada has usually ended up with the worst of both worlds: higher interest rates and a devalued dollar." This worst of both worlds most likely came about because

- a) tight monetary policy caused a balance of payments deficit to develop
- b) the risk premium increased at the same time as a current account deficit occurred
- c) higher inflation raised the nominal interest rate and caused the dollar to depreciate
- d) the Fed sold dollars on the foreign exchange market at the same time that it was selling bonds on the open market

12. "Prior to 1989 it was widely believed that New Zealand 10-year government bond interest rates could not fall below those of Australia. Once New Zealand rates fell below those of Australia the view on relative rates changed to one where New Zealand rates could not fall below those of the United States, due to the high liquidity of the U.S. bond market. But this also has been proved wrong." What must be happening to cause New Zealand rates to fall below those of Australia and the U.S.?

- a) inflation in New Zealand must be lower than in Australia and the U.S.
- b) unemployment in New Zealand must be lower than in Australia and the U.S.
- c) New Zealand's exchange rate must be falling relative to the Australian and U.S. dollars
- d) New Zealand must have an easy monetary policy while Australia and the U.S. have a tight monetary policy

13. "By narrowing the spread between short-term interest rates in Canada and the United States in line with the Canadian dollar forward rate, the Bank of Canada stopped the arbitrage activity that was pushing up the Canadian dollar." The difference between the Canadian and U.S. interest rates must have been

- a) zero in real terms
- b) bigger than the risk premium
- c) bigger than the expected fall in the Canadian dollar
- d) bigger than the risk premium plus the expected fall in the Canadian dollar

14. "While the chartered banks have so far refrained from raising their rates, the finance minister warned reporters that this situation cannot last. The Canadian and U.S. economies are so interrelated, he said, that it will be impossible for Canadian interest rates to remain much lower than U.S. rates for an extended period of time." This politician's statement is

- a) false because if the exchange rate is fixed Canada can have a lower nominal interest rate if its inflation rate is lower
- b) false because if the exchange rate is flexible Canada can have a lower nominal interest rate if its inflation rate is lower
- c) true because so long as Canada is riskier than the U.S. its interest rate must in the long run be higher than that of the U.S.
- d) true because international arbitrage forces will ensure that Canadian and U.S. real interest rates are roughly the same except for a risk premium

15. "Last week's movement was largely triggered by Bank of Canada concerns about the drop in the Canadian dollar in the face of higher U.S. interest rates." The movement referred to here is a higher Canadian

- a) interest rate b) inflation rate c) money supply d) unemployment rate

16. "The governor of the Bank of Canada urged Canadians today to continue the fight against inflation, but warned they cannot expect any significant drop in interest rates until the U.S. takes convincing action to reduce its budget deficit." Despite this statement, the Canadian interest rate could fall significantly if

- a) the risk premium were to rise b) the Canadian budget deficit fell significantly
c) Canadian money growth were increased and its exchange rate fixed
d) Canadian inflation were lowered and its exchange rate allowed to increase

17. "West Germany's decision to spend 85 billion dollars on reunification probably pushed up interest rates in the United States by half a percentage point." U.S. interest rates rose because

- a) the world real interest rate rose b) expected inflation in Germany rose
c) the nominal interest rate in Germany rose
d) the risk premium between the U.S. and Germany rose

18. "A recent study claims that Japanese households are likely to decrease their saving rate in the 1990s, but doesn't say what implication this will have for interest rates in the United States." U.S. interest rates will probably

- a) rise because the world interest rate will rise
b) fall because the risk premium with Japan should fall
c) fall because Japan will not be able to buy as many U.S. exports
d) fall because inflation in the U.S. should rise as higher Japanese consumption demand bids up U.S. prices

19. "People widely believe that there is a correlation between higher interest rates and capital inflows, but this belief is as false as the once accepted belief that there is a correlation between unemployment and inflation, causing the one to go up when the other goes down. These correlations don't stand up to scientific research." The correlation between interest rates and capital flows does not stand up because capital inflows are only affected by a higher interest rate if

- a) there is a current account deficit
b) there is a balance of payments deficit
c) it is a higher real interest rate
d) it is a higher real interest rate relative to foreign real interest rates

20. "U.S. money supply in the October-to-March period grew at a 10 percent annual rate, compared with growth of less than 1 percent between June and October last year. This behavior tends to weaken the U.S. dollar." This weakens the U.S. dollar because

- a) the Fed is not buying as many dollars on the foreign exchange market
b) this restrictive monetary policy is creating a balance of payments deficit
c) foreigners anticipate higher U.S. inflation, expect U.S. bond prices to fall and so capital inflows fall
d) foreigners anticipate lower U.S. inflation, expect U.S. bond prices to rise and so demand for dollars decreases because they buy bonds instead

21. "Analysts are wondering if Canadian yields can fall while U.S. yields are rising." This is

- a) impossible if the risk premium is constant
- b) possible if Canadian inflation falls while U.S. inflation rises
- c) possible if Canadian money growth exceeds U.S. money growth
- d) impossible because real interest rates are approximately equal everywhere

22. "Greenspan stated that what we have seen in the past is that the willingness of foreigners to hold dollars is closely related to their sense of soundness of our economic policies." Soundness here most likely means low

- a) taxes
- b) inflation
- c) unemployment
- d) real interest rates

23. Suppose the current exchange rate is 200 yen per dollar, the U.S. interest rate is 6 percent, the Japanese interest rate is 4 percent and there is no risk premium. What do you expect the exchange rate to be a year from now?

- a) 195 yen/\$ or less
- b) more than 195 yen/\$ but not more than 200 yen/\$
- c) more than 200 yen/\$ but not more than 205 yen/\$
- d) more than 205 yen/\$

24. Suppose the current exchange rate is 4 francs per dollar but is expected during the next year to rise to 4.4 francs per dollar. If the current U.S. interest rate is 6 percent, what should be the French interest rate on a comparable security, assuming a zero risk premium?

- a) 6% or less
- b) more than 6% but not more than 10%
- c) more than 10% but not more than 14%
- d) more than 14%

25. Suppose inflation in the U.S. is 8 percent, its real interest rate is 3 percent, and the real interest rate in Canada is 4 percent. Assuming a fixed exchange rate what is the Canadian nominal interest rate?

- a) 9% or less
- b) more than 9% but not more than 10%
- c) more than 10% but not more than 11%
- d) more than 11%

26. Suppose the United States and Canadian economies are in mutual equilibrium with a flexible exchange rate, both with long-run real growth of 2 percent. The U.S. money supply growth rate is 8 percent and its real interest rate is 3 percent. If the risk premium (Canada is riskier) is 1 percent, and the value of the U.S. dollar is appreciating by 1.5 percent per year, what is Canada's nominal interest rate?

- a) 10% or less
- b) more than 10% but not more than 11%
- c) more than 11% but not more than 12%
- d) more than 12%

Suppose Canada and the U.S., on a fixed exchange rate, have real growth rates of 2%, and a risk premium of 1% (Canada is riskier). Canada's real interest rate is 4% and the U.S. nominal interest rate is 8%.

27. Canada's inflation rate is

- a) less than or equal to 4%
- b) 5%
- c) 6%
- d) greater than 6%

28. Canada's nominal interest rate is

- a) less than or equal to 7%
- b) 8%
- c) 9%
- d) greater than 9%

29. Suppose the Canadian economy, on a flexible exchange rate, has a real growth rate of 3 percent and is increasing its money supply by 10 percent per year. Suppose changes in the U.S. cause its real interest rate to rise from 4 percent to 5 percent and its inflation rate to increase by 2 percentage points. Assuming a risk differential premium of one percentage point, after the Canadian economy has settled to a new equilibrium, what is its nominal interest rate?

- a) 12% or less b) more than 12% but not more than 13%
 c) more than 13% but not more than 14% d) more than 14%

30. Suppose under a flexible exchange rate system the current exchange rate is 4 francs per dollar, inflation in France is 5 percent and inflation in the U.S. is 10 percent. Suppose you are an American expecting to pay 10,000 francs in a year's time and wish to hedge against an unfavorable exchange rate movement. Approximately what forward exchange rate do you expect to pay?

- a) 3.6 fr/\$ b) 3.8 fr/\$ c) 4.2 fr/\$ d) 4.4 fr/\$

31. If the Canadian interest rate is 10%, the U.S. rate is 15%, the risk differential is 2% and the two economies are in mutual equilibrium

- a) the \$C is appreciating b) the \$C is depreciating
 c) Canadian exports are falling and imports rising d) both a) and c)

32. Suppose Canada and the U.S. are in equilibrium with a flexible exchange rate and a risk premium of 1% (Canada is riskier). The real rates of growth in Canada and in the U.S. are both 3%, but the U.S. interest rate is 10% and the Canadian interest rate is 7%. Relative to the Canadian dollar, the value of the U.S. dollar is

- a) rising b) falling by 2% per year c) falling by 3% per year d) falling by 4% per year

33. Suppose the Canadian economy, on a fixed exchange rate, has a real growth rate of 2% and is in equilibrium with an inflation rate of 10% and a risk premium of 1%. Suppose changes in the U.S. cause its real rate of interest to increase from 3% to 4% and its inflation rate to increase by two percentage points. When the Canadian economy has settled to a new equilibrium after this change, what is its nominal interest rate?

- a) less than 15% b) 15% c) 16% d) more than 16%

34. If inflation in the U.S. is 8%, and the real interest rate in Canada is 3%, then under a fixed exchange rate

- a) both real interest rates should be the same
 b) both nominal interest rates should be the same except for a risk differential
 c) the Canadian nominal interest rate should be higher than the U.S. nominal interest rate by more than the risk differential
 d) the U.S. nominal interest rate should be higher than the Canadian nominal interest rate by more than the risk differential

35. Canada, on a fixed exchange rate, has real growth of 2% and is in equilibrium with money growth of 10%. Changes cause the U.S. real i rate to rise by 1% pt., U.S. inflation to rise by 2% pts., and its risk differential with Canada (Canada is riskier) to drop by

0.5% pt. When the Canadian economy has settled to its new equilibrium, what is the change in its nominal interest rate?

- a) 1% pt. or less b) above 1% pt. up to 2% pts.
c) above 2% pts. up to 3% pts. d) more than 3% pts.

36. If there is a risk differential of 1% pt. between countries A and B then their

- a) real i rates should differ by 1% pt. b) nominal i rates should differ by 1% pt.
c) nominal i rates should differ by 1% pt. plus the difference in their real growth rates
d) real i rates should differ by 1% pt. plus the difference in their real growth rates

37. If the Canadian risk premium is 1% (Canada is riskier), the Canadian interest rate is 10% and the U.S. interest rate is 15% and the two economies are in mutual equilibrium

- a) the \$C will be depreciating relative to the US\$
b) the \$C will be appreciating relative to the US\$ by 4% per year
c) the \$C will be appreciating relative to the US\$ by 5% per year
d) the \$C will be appreciating relative to the US\$ by 6% per year

Suppose Canada and the U.S., on a flexible exchange rate, have real growth rates of 2%, and a risk premium of 1% (Canada is riskier). Canada's real interest rate is 4%, the U.S. nominal interest rate is 8%, and the value of the Canadian dollar is falling by 6% per year.

38. Canada's inflation rate is

- a) less than or equal to 8% b) 9% c) 10% d) more than 10%

39. Canada's nominal interest rate is

- a) less than or equal to 8% b) 9%, 10% or 11%
c) 12%, 13% or 14% d) more than 14%

40. Under a fixed exchange rate if US real growth is 2% and money supply growth is 8%, then if Canada's real interest rate is 4%, Canada's nominal interest rate

- a) should be about 10% b) should be about 12%
c) should be equal to the US nominal interest rate
d) depends on the rate of change of the exchange rate

Suppose the Canadian and U.S. economies, on a flexible exchange rate, have real growth rates of 2% and a risk premium of 1% (Canada is riskier). The Canadian money growth rate is 10%, the U.S. money growth rate is 7% and the U.S. real interest rate is 3%.

41. The Canadian nominal interest rate is

- a) 10% or less b) 11% c) 12% d) more than 12%

42. The value of the Canadian dollar is falling each year by

- a) less than 2% b) 2% c) 3% d) more than 3%

43. We can be confident that our dollar will appreciate if

- a) we have a balance of trade surplus b) we have net capital inflows

- c) our inflation rate is below that of other countries
- d) our nominal interest rate is higher than in other countries

44. Interest rate parity claims that

- a) real interest rates are identical across countries
- b) nominal interest rates are identical across countries
- c) real interest rates are identical across countries except for a risk differential
- d) nominal interest rates are identical across countries except for a risk differential

45. Under flexible exchange rates a small open economy should

- a) lose control of its monetary policy
- b) be insulated from its trading partners' inflation
- c) tend to experience the inflation of its trading partners
- d) find that changes in its interest rates match changes in its trading partner's interest rates

46. If monetary policy targets on an unemployment level less than the natural rate of unemployment, then over time

- a) the interest rate should rise
- b) the exchange rate should rise
- c) both real and nominal wages should fall
- d) the interest rate and GDP should remain roughly constant

"The Bank of Canada began easing monetary conditions in response to the recession and the resulting substantial reduction in inflationary pressures. While the Fed was also easing, the pace of easing in Canada exceeded that in the United States, resulting in a 300 basis point narrowing in the Canada-U.S. short-term interest rate spread. Surprisingly, this did not result in a decline in the value of the Canadian dollar; in fact, it strengthened."

47. From this information,

- a) inflation was falling at equal rates in both countries
- b) inflation in Canada must have been falling faster than in the U.S.
- c) inflation in the U.S. must have been falling faster than in Canada
- d) not enough information to determine relative declines in inflation rates

*48. The Canadian dollar strengthened because

- a) the 300 basis point narrowing was too much narrowing
- b) the Bank of Canada intervened directly in the foreign exchange market
- c) the real interest rate spread must have widened, despite the 300 basis point narrowing
- d) there is no rational explanation for the strengthening of the Canadian dollar

49. "Annual inflation is at 35% and expected to rise to 45% by the end of the year. Interest rates are already at 40%. The Zimbabwe dollar has dropped in value by more than 55% this year." The Zimbabwe real interest rate is

- a) positive, and its real exchange rate has decreased
- b) negative, and its real exchange rate has decreased
- c) positive, and its real exchange rate has increased
- d) negative, and its real exchange rate has increased

50. "Argentina's _____ is measured by the spread between yields on Argentine dollar-denominated bonds and U.S. Treasuries." The blank is best filled with
 a) risk premium b) real interest rate c) expected inflation d) nominal interest rate
51. "Years of high growth generally _____ inflation, which in turn prompts the Federal Reserve to _____ interest rates, a step that runs the risk of triggering _____." The blanks are best filled with
 a) fuel; raise; a recession b) reduce; cut; a recession
 c) fuel; lower; inflation d) reduce; raise; inflation
52. "The Federal Reserve chairman told congress that "the Fed is unlikely to raise interest rates in the near future." He also stated that "a strong signal of inflation pressures has not yet clearly emerged." These statements are
 a) inconsistent because inflation is improperly measured
 b) consistent because the Fed is following the monetarist rule
 c) consistent because higher interest rates are only needed to fight inflation
 d) inconsistent because higher inflation will automatically cause nominal interest rates to rise
53. "Fans of the new-economy theory say U.S. businesses have become so efficient, and the world so open and competitive, that workers deserve _____ and businesses can't get away with _____. The fluke school argues that temporary factors- low energy prices, a strong dollar, and weak demand in Asia - will eventually go away, causing _____." The blanks are best filled with
 a) wage freezes; layoffs; inflation b) wage increases; raising prices; inflation
 c) to be unemployed; layoffs; unemployment
 d) wage decreases; raising prices; unemployment
54. "Higher interest rates must boost the cost of all sorts of things for business. How can higher interest rates be anti-inflationary?" Higher interest rates are anti-inflationary because they
 a) lower the price of bonds b) dampen aggregate demand
 c) encourage imports which increases supply of goods and services
 d) are caused by the premium for inflation in nominal interest rates
55. "Some bankers say Turkey's lax approach to state finances could end in disaster. Inflation last year was 96% and the state is now servicing its debts at a compound interest rate of 123%, a real rate of 27%." Suppose the "world" real interest rate is 3%. The 27% calculation seems to contradict IRP. This is best explained as
 a) Turkey's risk premium is 24% b) Turkey's expected inflation is 120%
 c) IRP is not relevant to this Turkish example
 d) Turkey's expected inflation is much higher than 96%
56. "But economists predict most countries will conclude that their best course is to make floating rates more tolerable, for example, by increasing opportunities for companies and banks to hedge themselves against currency swings." What is meant by "to hedge themselves against currency swings"?
 a) engaging in simultaneous buying and selling of foreign currency

- b) requiring of foreigners that all payments be made in domestic currency
- c) buying foreign currency on the forward market when export sales receipts are expected
- d) selling foreign currency on the forward market when export sales receipts are expected

57. "But that still leaves an enormous five percentage point spread between the world's two most powerful central banks - 8% in Germany and 3% in the U.S. The question raised when the German - American spread began to widen last year was: Who is following the right policy? A possible answer is that both central bank leaders were following the right policy." Both central banks could be following the right policy here because

- a) inflation was increasing in Germany but not in the U.S.
- b) unemployment was higher in the U.S. than in Germany
- c) the risk premium for investing in Germany had risen
- d) the clipping is wrong - the spread should be narrowing

58. "When interest rates abroad are rising rapidly as they have risen in recent months, the scope for Canadian interest rates to lag behind foreign rates is necessarily limited unless we want to invite yet further substantial depreciation of the currency." Is this statement correct?

- a) yes because of purchasing power parity
- b) no because we can fix the exchange rate
- c) no because it is the real interest rate that is relevant here
- d) yes because relatively lower Canadian interest rates would decrease capital inflows

59. "Pressures from a household spending spree and the buoyant building sector won the battle to determine interest rates yesterday, but the central bank hinted that the strong currency could win the war." What most likely happened to interest rates?

- a) they rose
- b) they fell
- c) they were unchanged
- d) can't tell

Answers: 1c 2c 3a 4d 5d 6a 7d 8a 9c 10b 11c 12a 13d 14b 15a 16d 17a 18a 19d 20c 21b 22b 23b 24d 25d 26c 27b 28c 29b 30b 31a 32d 33d 34b 35c 36a 37d 38d 39d 40a 41c 42c 43c 44c 45b 46a 47b 48c 49b 50a 51a 52c 53b 54b 55d 56d 57a 58c 59a